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TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

MAY 16 AND 17, 1989

PART II

Serial 101-42

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TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

TUESDAY, MAY 16, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 10:06 a.m., in room 1100, Longworth House Office Building, Hon. Byron Dorgan presiding.

[The press release announcing the hearings follow:]

FOR IMMEDIATE RELEASE
WEDNESDAY, APRIL 12, 1989

PRESS RELEASE #13
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE CONTINUATION OF HEARINGS ON THE TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, announced today that the Committee will continue its hearings on tax policy issues with respect to mergers, acquisitions, leveraged buyouts and recent increases in corporate debt. The hearings will be held on Tuesday, May 16, Wednesday, May 17 and Thursday, May 18, 1989, beginning at 10:00 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building.

In announcing the continuation of these hearings, Chairman Rostenkowski stated. "The Committee plans to continue its comprehensive review of the complex issues surrounding the tax treatment of corporate debt and equity. Earlier this year, the Committee conducted five days of public hearings on these issues. Based upon the testimony received by the Committee and the interest of the Members in these issues, I asked that Members submit legislative options for consideration by the Committee in a public hearing. In this way, the Committee will be provided the opportunity to receive testimony on specific options for change before any decision is made to legislate on these issues.

"The options submitted for review by the Members, along with options submitted by staff, are contained in this press release. I want to emphasize that no decision has been made by the Committee at this time regarding whether or not to draft legislation proposing to change the tax treatment of corporate debt and equity. The options contained in this press release are listed for purposes of public comment only."

SCOPE OF THE HEARINGS:

A. Comments applicable to all legislative options.

The Committee invites the public to comment on a series of legislative options submitted by Members of the Committee and staff. Testimony is requested concerning the fairness of each proposal, and the tax and economic policy implications of each option. In addition, the Committee requests testimony regarding the practical feasibility and administrability of each proposal. Also, the Committee is interested in comments comparing the relative strengths and weaknesses of the various options.

The Committee anticipates that if any option is ultimately considered for legislative action, such option would contain fair and adequate transition relief for transactions in which taxpayers have reasonably relied upon existing rules. It is anticipated such relief would be designed so as not to disrupt the orderly conduct of financial markets. The Committee invites testimony on the proper scope of transition relief for each legislative option.

The revenue impact, if any, of the following options is unknown. It is anticipated that if any option is ultimately considered for legislation and such option would increase revenues, such revenues would be utilized to finance related options providing some form of tax relief, such as proposals allowing a deduction or credit for payments made by a corporation with respect to equity. It should also be noted that because of budget constraints, the Committee anticipates that options which, if enacted, would result in a loss of revenue could only be considered along with companion options which would raise a similar amount of revenue.

The Committee requests testimony on the potential impact, if any, of each option on domestic and international markets. In addition, testimony is requested regarding the possible impact of any option on the competitiveness of U.S. corporations with foreign acquirers.

Moreover, with respect to each option affecting foreign persons, the Committee is interested in receiving comments on the discriminatory or nondiscriminatory nature of the option, and on proposals for eliminating any perceived or actual discrimination. In addition, comments are requested regarding any potential impact on current and future tax treaties with foreign countries.

The Committee also requests testimony on the potential impact, if any, of each option on specific industry segments, such as small business or financial institutions, including possible modifications of options which should be considered by the Committee. In addition, testimony is invited regarding whether threshold dollar amount exceptions are advisable with respect to any of the options.

Testimony is specifically requested regarding limiting the applicability of any option to transactions involving a high-dollar threshold, such as $100 million. Another possible restriction would be to apply the proposals only to transactions where the interest incurred exceeds a certain threshold, such as $10 million, or higher, per year or per acquisition. In addition, testimony is requested with respect to the purchase of assets or stock of wholly-owned subsidiaries of other corporations, and negotiated purchases of stock of closely-held corporations in friendly transactions with owners of such stock or assets. Testimony is also requested regarding limiting the scope of any option to takeovers of a "publicly-owned" company, (for example, a company with 100, 250 or more shareholders, a company registered under section 12 of the Securities and Exchange Act of 1934, or a company whose shares are listed for trading on an exchange or through NASDAQ).

B. Options modifying the current tax treatment of corporate interest.

1. Interest deductions could be denied on debt incurred or continued to purchase 20 percent, or more, of the stock of a corporation in a hostile tender offer, or to purchase assets of a corporation following such a stock purchase (H.R. 158). A hostile tender offer would be defined as one disapproved by a majority of the independent members of the board of directors of the target corporation. In addition, all gain would be recognized at the corporate level in the case of an acquisition of 80 percent, or more, of the stock of a corporation where a significant portion of the stock was purchased pursuant to a hostile tender offer.

2. The deduction for interest could be denied for debt incurred to finance mergers determined not to be in the public interest, specifically those transactions that result in a significant loss of jobs (H.R. 679). If the merger is expected to reduce employment by more than 100 employees in the location of the establishment, the Federal Trade Commission would

determine (i) the economic reasons for the proposed reduction in employment, (ii) the extent of economic losses to those employed by the establishment in which the reduction will occur, (iii) the extent of any economic loss, including a decline in the tax base, of any local government unit and any person in the geographic area in which such establishment is located and (iv) other findings. If the Federal Trade Commission finds that the proposed merger would have a substantial adverse effect on employment in a county, city or other jurisdiction, the interest-deduction limitations would apply.

3. The deduction for interest payments on certain high-yield or so-called "junk bond" debt could be denied above a specified threshold amount. The threshold exemption would be provided for a certain dollar limit of debt, such as $50 million, on an issue-by-issue or aggregate basis. A junk bond could be defined as an instrument that possesses one, or more, of several characteristics, such as an excessively high interest rate (as measured by some number of percentage points over the prime rate or the applicable federal rate (AFR)), significant subordination to other debt of the issuer, convertibility into equity, or a non-investment-grade bond rating. Such restrictions could be applied to junk bonds used in a broad class of stock or asset acquisitions, including stock buybacks, or such restrictions could be limited to a narrower class of circumstances, such as hostile takeovers.

4. The deduction for corporate interest could be reduced by a specified percentage. Under the proposal, the revenues raised by such modification would be utilized to provide a percentage deduction for dividend payments made by corporations. The percentage deduction allowed for corporate interest would be the same as the percentage deduction allowed for dividend payments. This percentage would be determined on a revenue-neutral basis.

5. The deduction for corporate interest expense could be fully repealed and replaced with a credit to shareholders representing the corporate taxes paid on the earnings distributed to shareholders as a dividend. Depending upon the revenue consequences of such a proposal, the scope of these rules could be modified for companies whose shares are not publicly owned.

6. A corporate taxpayer's deduction for interest in excess of a specified rate of interest could be disallowed in whole, or in part. The rate above which the interest deduction would be disallowed would be selected by reference to some number of percentage points over the AFR. For example, disallowance could apply to interest in excess of 3, 6 or 9 percentage points over the AFR at the time the instrument was issued. This option would not affect the characterization of an obligation as debt or equity under present law. Special anti-avoidance rules could address issues such as the possible ability of taxpayers to issue debt qualifying under the option for full deductibility, which debt subsequently is securitized into a combination of lower-rate instruments, plus higher-rate instruments that would not have qualified for full deductibility if issued directly by the corporation.

7. A normative level of debt to equity of a corporation could be established, such as 80 percent. Any transaction which results in debt to equity levels above this percentage would be penalized, for example, through the imposition of a 50-percent reduction in the deductibility of interest on the debt incurred. The option might also be designed with a different ratio, such as debt to net worth, not counting junk bonds.

8. The deduction for corporate interest expense could be replaced with an annual percentage deduction based upon the overall capitalization of a company. The percentage deduction for capital would be established on a revenue-neutral basis, according to revenues raised by the denial of the current law deduction for corporate interest. For nonfinancial corporations,

overall capitalization would include the sum of recorded shareholders' equity, plus the average of any loans for which the interest rate paid is greater than the percentage rate set for capital deductions. For financial corporations, only equity would be counted toward overall capitalization, but such corporations would be allowed to offset interest expense against interest income, so long as net interest income would be positive.

9. Corporate interest deductions for interest expense that is not actually paid currently could be deferred with respect to original issue discount (OID) obligations in transactions in which debt replaces corporate equity, until such time as interest amounts were actually paid. The amount of the ultimate deduction could be increased to reflect the time value of the deferral of the deduction. The proposal could be tailored to only apply to OID obligations held by tax-exempt entities and foreign persons.

As an alternative to postponing interest deductions of the issuer, OID from obligations which result in the replacement of corporate equity with debt could be treated as unrelated business income for tax-exempt entities. In addition, foreign holders of such obligations could be subject to full current taxation. Anti-avoidance rules would govern situations in which such OID obligations are held through intermediaries.

C. Options modifying the current tax treatment of equity distributions made by corporations.

1. A shareholder-level credit could be provided in an amount equal to the corporate tax paid with respect to a percentage of dividends paid by a corporation. Shareholders would include in income the total amount of the dividend and the credit, and then would offset income tax liability by the amount of the credit. In this manner, a portion of the corporate-level tax on earnings distributed as dividends would be relieved.

2. Shareholders could be provided an exclusion from income for a percentage of dividend income.

3. Corporations could be provided a deduction for a percentage of dividends paid to shareholders. This option could be modified to reduce the deduction to the extent of holdings by foreign and tax-exempt shareholders, or, alternatively, to impose a compensating tax on such shareholders.

Each of the above options could apply only to equity raised by a corporation after the enactment of the proposal, or could be applied to both existing and newly-raised equity.

D. Options relating to investment banking fees.

1. A nondeductible excise tax could be imposed on compensation derived by any party earning income in a leveraged buyout. The proposal would include a 5-percent excise tax on all parties earning a profit in such transactions. In the case of fees earned by managing investment banking firms and other leveraged buyout managers, an additional excise tax on management fees of 20 percent would be assessed, resulting in a total excise tax of 25 percent with respect to fees earned by these parties.

2. A nondeductible excise tax could be assessed on excessive compensation derived by individuals from services rendered in connection with merger and acquisition activity. The excise tax rate could be as high as 50 percent, as a means of achieving a substantial deterrent effect. The compensation subject to the excise tax would be an amount that exceeds a specified threshold (such as $50 million a year).

(MORE)

3. A nondeductible excise tax could be assessed on so-called "two-tiered" rate structures for advisory fees which are based upon the success of an offer. In addition, a nondeductible excise tax could be assessed upon financial advisors both providing an independent appraisal of the target company's assets and playing a role in a tender offer for the same company.

E. Options relating to the tax treatment of foreign persons and to issues of foreign investment.

1. With respect to any domestic corporation controlled by foreign persons, an additional amount could be included in the domestic corporation's gross income, to account for interest that would have been disallowed under any of the above options, except for the fact that it was incurred by a related foreign corporation outside the United States. For example, under option B.6 above, the corporation could be required to determine the amount of worldwide interest, if any, paid by related foreign corporations that would be disallowed if paid by a corporation subject to U.S. tax, as set forth in that option. An amount of such worldwide excess interest would be allocated to the investment in the U.S. corporation. To the extent that such excess interest is allocated to the investment in the U.S. corporation, and is greater than interest paid by the U.S. corporation and otherwise disallowed under rules applicable to all corporations subject to U.S. tax, such interest would be treated as additional gross income to the U.S. corporation. For these purposes, rates on non-U.S. dollar denominated debt would be adjusted to comparable dollar interest rates, taking into account anticipated foreign exchange gains and losses. Corporations that fail to properly account for all worldwide interest payments would be subject to mandatory income inclusions. An exemption would be provided for foreign persons operating only in countries certified by the Treasury Department as imposing effective interest-deduction rules that eliminate any substantial competitive advantage for investors residing in such countries.

2. A 30-percent withholding tax could be imposed on interest earned by foreign persons on portfolio debt in the United States. Such a tax was previously required by the Internal Revenue Code until it was repealed in the Deficit Reduction Act of 1984. The 30-percent withholding tax could be applied notwithstanding exceptions such as tax treaties that provide for lower or zero-withholding rates on interest payments, or the withholding percentage could be reduced in accordance with existing tax treaties. Under another version of this proposal, the withholding rate could be set at a minimum of 5 percent on all interest, overriding tax treaties where necessary. As an alternative to requiring withholding on all portfolio interest, an exemption could be provided for interest paid on debt backed by the full faith and credit of the United States.

3. A corporate taxpayer's deduction for interest paid to certain related parties, in so-called "earnings stripping" transactions, could be limited. For these purposes, an "earnings stripping" transaction could be defined as one in which a corporation's net interest payments (or net payments serving as a proxy for interest, such as certain types of lease payments) exceed a threshold percentage of the corporation's taxable income. Such taxable income would be determined without regard to net interest expense and net operating loss carryovers. The option could be targeted to reach only those cases where the recipient of the interest payments would not be subject to U.S. income taxation on those payments.

4. An amortization deduction for goodwill could be provided for U.S. corporations. For example, goodwill could be amortized over a 40-year period. A modification of this proposal would allow the amortization deduction for goodwill only in cases where a taxable acquisition of a U.S. corporation is made. In addition, the proposal could provide an amortization deduction for goodwill only to the extent that goodwill exceeds 10 percent of the value of a corporation's assets.

As an alternative, U.S. treaty policy could be reviewed to address situations where foreign countries provide benefits not provided by the U.S. that may give foreign acquirers an advantage over U.S. acquirers, such as the amortization of goodwill.

5. Gain realized by foreign persons on the liquidation of a U.S. corporation (which is generally exempt from U.S. tax unless the gain is effectively connected with the conduct of a trade or business in the U.S., or the foreign person is an individual present in the U.S. for at least 183 days during the taxable year) could be taxed as a dividend, to the extent of earnings and profits. Gains so treated could be subject to U.S. withholding tax at the 30-percent rate imposed on dividends, or at reduced treaty rates where applicable. This liquidation tax could be imposed notwithstanding contrary provisions of existing tax treaties, or the option could be imposed only where permitted by applicable tax treaties.

In a similar manner, gain realized by foreign persons on the sale of stock in a U.S. corporation could be taxed as a dividend, to the extent of earnings and profits, where the gain is not effectively connected with the conduct of a trade or business.

F. Options modifying the tax consequences relating to certain corporate financing transactions.

1. A nondeductible excise tax could be imposed upon the value of assets acquired pursuant to certain stock or asset acquisitions. The proposal could be made applicable to the acquisition of a defined amount of stock (such as 50 percent or more), or assets (such as substantially all assets or those assets constituting a discrete line of business) of a corporation. The transactions in which the excise tax would be imposed could be all acquisitions, or could be limited in scope, for example, to hostile takeovers.

The rate of the excise tax could be in the range of 3-5 percent, depending upon revenue considerations. Revenues raised by such a tax could be used as a revolving fund to help small business and venture capital situations. In addition, exemptions could be provided for transactions under a certain threshold amount (such as $50 million), and for transactions where a full corporate-level tax has been paid as a result of the acquisition.

2. A 50-percent exclusion could be provided for gain from the sale of an asset which is both (i) financed through corporate or individual equity (or savings) and (ii) held for a minimum of three years.

3. A corporation could be required to recognize gain on its appreciated assets when it borrows against those assets and distributes the proceeds to its shareholders. Such treatment would be similar to current-law recognition of gain by a corporation when it distributes appreciated assets. The proposal would only apply to the extent that the distributions exceed the amount of the shareholders' contributions to the capital of the corporation, plus the accumulated earnings of the corporation.

(MORE)

Under the proposal, gain would be recognized to the extent that the liabilities of a corporation exceed the sum of the aggregate basis of all the assets of the corporation, plus any accumulated deficit in earnings and profits. The aggregate basis of all assets would be the basis used in computing earnings and profits. Accordingly, borrowing would not produce gain recognition solely because of accelerated depreciation, or other tax benefits that do not reduce basis for earnings and profits purposes. Any accumulated deficit in earnings and profits would be added to basis in determining the amount of liabilities that may be incurred before gain is recognized, in order to prevent gain recognition from occurring solely by reason of a corporation incurring losses. Where gain is recognized under the proposal, such gain would be allocated to all of the corporation's assets, including goodwill, and would increase the basis of such assets.

G. Options relating to Employee Stock Ownership Plans (ESOPs).

1. The present law rule allowing financial institutions to exclude from income 50 percent of the interest income received with respect to loans to ESOPs or to employers making loans to ESOPs, could be repealed or reduced, in order to reduce the differences in tax treatment between the use of debt and equity in corporate financings.

2. The deduction for dividends paid on employer securities held by an ESOP could be repealed, or could be repealed to the extent that the dividends are used to repay an acquisition loan. (To the extent dividends would become deductible pursuant to other options which may be considered by the Committee, however, a deduction could be allowed for these dividends.)

3. Present law rules could be modified so that an ESOP would not be treated as a qualified plan unless the ESOP was a supplemental retirement plan. Accordingly, the employer would be required to maintain another meaningful qualified plan as a means of protection for participants participating in ESOPs that are 100-percent leveraged, or are the only qualified plan maintained by the employer. As an alternative, the exposure of plan participants, in the event a company does not repay an ESOP loan, could be limited by providing that the acquisition of shares by an ESOP could not be 100-percent leveraged.

H. Miscellaneous.

Tax benefits could be reduced in the case of non-compliance with one, or more, of certain possible statutory and regulatory requirements dealing with mergers and acquisitions. For example, interest on debt incurred in a transaction not adhering to a specific requirement could be subject to a 50-percent reduction in deductibility. This restriction could be applied with respect to several possible rules governing acquisition transactions. The defense period for outside takeovers could be increased to 60 days. The period in which competing offers can be made during a management buyout could be increased to 90 days. Steps could be taken to minimize insider trading by ensuring that the board charged with deciding among competing proposals is truly independent. At a minimum, a majority of the board would be outside members, and a clear majority (two-thirds) would be needed to approve any management takeover. In addition, while it may not be feasible to have the Securities and Exchange Commission (SEC) approve all leveraged buyouts and other corporate acquisitions on a case-by-case basis, requiring SEC approval of management buyouts could be a safeguard against inside deals.

Furthermore, the Committee could recommend that creditors and suppliers be notified when a company's debt to net worth ratio (or other standard) reaches a certain level, so actions can be made with full knowledge of a company's financial condition. In addition, with respect to the differing treatment of goodwill by different countries, the Committee could recommend that the SEC selectively waive the so-called "push down rule", which requires that goodwill associated with a purchase or merger remain on the books of a company when it returns to the U.S., even if such amount was written off abroad.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriett Lawler or Diane Kirkland [(202) 225-1721] no later than Friday, May 5, 1989, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff [(202) 225-1721].

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearings. (See formatting requirements below.) In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Committee are requested to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of the scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearings should submit at least six (6) copies of their statements by the close of business Friday, May 26, 1989, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building Washington, D.C. 20515. If those filing written statements for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the beginning of the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. **All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.**
2. **Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.**
3. **Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.**
4. **A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.**

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Mr. DORGAN. If you will take your seats, we would like to begin the hearing today.

The chairman is on his way back from a meeting at the White House this morning and will be here momentarily. He has asked that I initiate proceedings in this hearing.

Today the committee begins its sixth day of hearings on the tax and economic policy aspects of leveraged buyouts and other transactions that resulted in corporate equity being replaced by debt. During the previous 5 days of hearings on this topic, members of the committee have had the opportunity to hear from many Government policymakers, practitioners and other experts on the potential economic impact of these transactions.

As a result of the interest of the members in the issues, and the testimony received by the committee, Chairman Rostenkowski has asked the members to submit specific legislative options for consideration by the committee in public hearings. The options submitted for review by the members, along with options submitted by the staff, are contained in the committee's press release, dated April 12, 1989. The chairman requests that a copy of this press release be entered into the record.

Chairman Rostenkowski stated in that press release that these legislative options have been set forth for the purpose of obtaining public comment and notices had been made by the committee at this time regarding whether or not to draft legislation proposing to change the tax treatment of corporate debt and equity.

Members of the committee will be very interested in the testimony we will receive today and tomorrow on the specific legislative options, and also on issues like fair and adequate transition rules for any proposal which might subsequently be considered.

The chairman and the rest of the committee hopes the testimony we receive today and tomorrow will be constructive and assist the members of the Ways and Means Committee in reviewing these complex issues.

The first witness this morning is Congressman Christopher Cox. It is a pleasure to have you appear before us today. Your full statement will be made a part of the permanent record, and we ask that you summarize. And we appreciate having you here.

STATEMENT OF HON. C. CHRISTOPHER COX, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA AND CHAIRMAN, HOUSE REPUBLICAN TASK FORCE ON CAPITAL MARKETS

Mr. Cox. Thank you very much. It is a pleasure to be here on this side of the hearing room.

I appreciate very much your inviting me here this morning to be the leadoff witness in these very important hearings about the tax aspects of mergers and acquisitions.

I appear here this morning not just as the chairman of the House Republican Task Force on Capital Markets. For 8 years, I was myself a corporate finance practitioner, advising individual investors, investment bankers, and companies engaged in mergers and acquisitions, public offerings, tender offers and leveraged buyouts.

I have also taught a course at Harvard Business School, entitled "Tax Factors in Business Decisions," the focus of which was very much on the subject matter of today's hearings.

During the past two decades, I have not only observed the development of America's capital markets, but I have participated in those markets as the founder of a business which sold shares to venture capital investors.

From each of these perspectives—as a teacher, corporate lawyer, and entrepreneur—I have been continually impressed with the efficiency of America's capital markets in pooling the resources of millions of individuals in order to create new jobs, new products, new wealth, and a higher standard of living for the people of our country.

Frankly, American's capital markets, as presently constituted, are the envy of the world. The Tokyo Stock Exchange pales in comparison to what we have in New York, Boston, Philadelphia, Chicago, Denver, San Francisco, and Los Angeles, to name only a few.

When I worked as legal counsel to President Reagan in the White House, one of my most interesting assignments was to assist the President in responding to questions from Izvestia, the second largest newspaper in the Soviet Union, about the precipitous drop in our stock market in 1987. I recommended that the President respond to the millions of Russians who would read his answers by explaining what a stock market is, what it does, and how it works—because, of course, the Soviet Union does not have a stock market.

The President's response did just that. He pointed out that, through our stock market, anyone who has a business idea can have access to the investment capital necessary to pursue it. As a result, President Reagan noted, here in America, Americans enjoy such things as personal computers, compact disc stereos, and car telephones; and our standard of living is three times higher than that of people in Communist countries.

It is not idle talk to focus on the very essentials of what stock markets and capital markets do for us, because most of the proposals before this committee today would substitute the judgment of the Federal Government for the judgment of investors in America's capital markets. In so doing, these proposals would make the markets less free and less efficient, thereby reducing investment, job creation, and the wealth of the American people.

It has been argued that leveraged buyouts, mergers and acquisitions are bad things which should be deterred or done away with. To accomplish this objective, this committee is considering the following: Reducing or eliminating the deductibility of interest on takeover indebtedness; eliminating the deductibility of interest on debt that the Federal Government determines is not in the public interest; the establishment by the Federal Government of a so-called normative debt-to-equity ratio for U.S. business, and the imposition of a penalty tax on companies with a different ratio; a 25-percent penalty tax on compensation earned in connection with leveraged buyouts; a 50-percent penalty tax on specialists in mergers and acquisitions for compensation determined by Federal regulators to be excessive; a penalty tax on acquisitions, whether of stock or assets, if the value of the acquisition is over $50 million; and the elimination of tax deductions presently available to employee stock ownership plans.

It seems obvious that the intent of all of these proposals is, if you will, rather hostile to tender offers—not to mention leveraged buyouts and similar transactions. This hostility is without solid foundation. Perhaps just as importantly, even if the hostility were legitimate, the proper means of regulating the Nation's capital markets is through the securities laws, not through the back door using our tax laws.

In this connection, I cannot help but draw attention to the statement by the committee issued in its public announcement of these hearings that "the revenue impact, if any, of the options being considered here today is unknown." In other words, the purpose of all of these proposals is not to provide ways and means for the operation of the Federal Government, but rather to penalize, deter or do away with mergers and acquisitions and leveraged buyouts. If that is the purpose of this Congress, we would be much better served to achieve that purpose directly, rather than through hamfisted attempts to use the tax laws to manipulate the financial returns of these transactions.

But that leveraged buyouts, mergers and acquisitions ought to be done away with or deterred is a wrong-headed assumption in the first place.

One frequent refrain, for example, is that the substitution of debt for equity deprives the Treasury of income tax revenues. On this subject, I have been particularly interested in the disagreement between two of my Harvard colleagues, Bill Andrews, who was my tax professor at Harvard Law School 12 years ago, and Michael Jensen, with whom I served on the faculty of the Harvard Business School.

Professor Andrews, in his testimony before the Senate Finance Committee, asserted that the Government's tax take is virtually sure to be far less after an LBO. And like many academics, he attempts to prove the truth of this statement in theory, rather than relying on data from the real world. Professor Jensen, on the other hand, in his testimony before this committee, cited empirical studies which show that the Andrews subsidy argument ignores three important factors.

First, while LBO's, in fact, typically reduce a firm's corporate income tax immediately after the transaction, they also generate large offsetting revenue increases in the form of capital gains taxes paid by the prebuyout shareholders who are forced to realize all of the gain on their holdings.

Second, the so-called subsidy argument also ignores the empirical evidence that, after an LBO, a company's tax payments typically return to the prebuyout level by the third year.

Finally, Professor Jensen observed that there are always substantial income tax payments by the buyout firm creditors who, of course, receive the interest payments and must treat them as taxable ordinary income.

As a result, Professor Jensen concludes, in the case of an average buyout with a price of $500 million, the net effect on Treasury tax revenues is to increase them by approximately $110 million.

For those of you who would prefer to look at the U.S. Government's income statement rather than empirical studies by Harvard professors, I would point out that the LBO era has been one of substantially increased Federal revenues from the corporate income tax. Beginning with 1983, the first year of the recovery, through the current fiscal year, it is estimated that revenue from corporate income taxes will have increased by more than $69 billion. That is a 189-percent increase. During the same period, revenue from individual income taxes increased 47 percent.

Another specter often raised in connection with leveraged buyouts is that jobs are lost when the new owners are forced to lay off workers in order to meet debt service requirements. This is a strange sort of flat Earth view of the economy, since the purpose of postbuyout management is to increase profitability by cutting costs, in the process making the company more efficient and more competitive. Does anyone seriously argue that less efficient companies with higher overhead make America more competitive internationally? If all this LBO activity of recent years had a materially adverse effect on employment, one would hardly expect to see America continuing with the longest peacetime economic expansion in our history, with the percentage of our population employed at an alltime high, and with the unemployment rate at a 15-year low.

I would like, if I might, to summarize quickly the balance of my testimony, pointing out the following:

In a study soon to be released by the National Bureau of Economic Research, Professors Brown and Medoff report that "contrary to public press coverage, we find that wages generally grow faster following acquisitions. We also find employment grows faster."

One of the first things that all of us learn about capital markets is that they fluctuate. We have had down markets in the past, and we will have them in the future. When I first began as a corporate finance practitioner, the public offering market was dead. Year after year, there was drought in the markets, and investment banking was not a very popular occupation for graduating MBA's. In those years, Jimmy Carter was urging this committee to impose penalty taxes on so-called windfall profits in the energy industry.

Today, when the oil patch is hurting and Wall Street is in robust good health, many of the same people who brought us the ill-considered windfall profits tax are urging these latest regulatory attacks on our economy. These attacks ignore the fundamental relationship between risk and reward.

If we really wish to improve the workings of America's capital markets, we will choose not to make debt financing less attractive for American business. Instead, we will seek ways to make equity investment just as attractive as debt, by eliminating the double taxation of dividends and reducing the rate of tax on capital gains.

As most of you know, reducing the rate of tax on capital gains would generate a huge increase in Federal revenues. The only argument is about how many billions of dollars that increase would be. Those billions of dollars would serve to offset any static revenue losses from a shareholder dividend credit.

Restoring the intended economic benefits of equity ownership would go far to eliminating the current disparity between asset values and share prices which is one of the principal attractions to arbitrageurs to engage in leveraged buyout transactions. It would address the real issue of how to make America more competitive by encouraging increased savings, job creation and wealth creation, instead of hobbling America's competitive position by increased taxation and regulation of our capital markets and the American men and women who participate in them.

Thank you.

[The statement of Mr. Cox follows:]

TESTIMONY OF
CONGRESSMAN CHRISTOPHER COX

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

HEARINGS ON
THE TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

TUESDAY, MAY 16, 1989

Mr. Chairman, I appreciate very much your inviting me to be the lead off witness in these most important hearings on the tax aspects of mergers and acquisitions.

It is not just as the Chairman of the House Republican Task Force on Capital Markets that I appear before you today. For eight years, I was myself a corporate finance practitioner, advising individual investors, investment bankers, and companies engaged in mergers and acquisitions, public offerings, tender offers, and leveraged buyouts.

I have also taught a course at Harvard Business School entitled "Tax Factors in Business Decisions." The focus of that course was very much on the subject matter of today's hearings.

During the past two decades, I have not only observed carefully the development of America's capital markets, but I have participated in those markets as the founder of a business which sold shares to venture capital investors.

From each of these perspectives--as a teacher, corporate lawyer, and entrepreneur--I have been continually impressed with the efficiency of America's capital markets in pooling the resources of millions of individuals in order to create new jobs, new products, new wealth, and a higher standard of living for the people of our country.

Frankly, Mr. Chairman, America's capital markets are the envy of the world. The Tokyo Stock Exchange pales in comparison to America's many markets in New York, Boston, Philadelphia, Chicago, Denver, San Francisco and Los Angeles, to name only a few.

When I worked as legal counsel to President Reagan in the White House, one of my most interesting assignments was to assist the President in responding to questions from Izvestia, the Soviet Union's second largest newspaper, about the precipitous drop in the U.S. stock market in 1987. I recommended that the President respond to the millions of Russians who would read his answer by explaining what a stock market is, how it works, and what it does--because of course, the Soviet Union does not have a stock market. The President's response did just that. He pointed out that through our stock market, anyone who wishes to pursue a business idea can have access to the investment capital necessary to pursue it. As a result, President Reagan noted, Americans enjoy such things as personal computers, car telephones and compact disc stereos, and the standard of living in the U.S. is more than three times that of people living in communist countries.

It is not idle talk to focus on the very essentials of what free and open capital markets really do for us, because most of the proposals before this Committee today would substitute the judgment of the federal government for the judgment of investors in the capital markets. In so doing, these proposals would make the markets less free and less efficient, thereby reducing investment, job creation, and the wealth of the American people.

It has been argued that leveraged buyouts, mergers, and acquisitions are bad things which should be deterred or eliminated. To accomplish this objective, this Committee is considering:

- eliminating the deductibility of interest on takeover indebtedness;

* eliminating the deductibility of interest on debt that the federal government determines is not in the "public interest";
* the establishment by the federal government of a "normative" debt-to-equity ratio for U.S. business, and the imposition of a penalty tax on companies with a different ratio;
* a twenty-five percent penalty tax on compensation earned in connection with leveraged buyouts;
* a fifty percent penalty tax on specialists in mergers and acquisitions for compensation determined by federal regulators to be "excessive";
* a penalty tax on acquisitions, whether of stock or assets, if the value of the acquisition is over $50 million; and
* the elimination of tax deductions presently available to employee stock ownership plans.

The obvious intent of all of these proposals is, if you will, rather hostile to tender offers--not to mention leveraged buyouts and similar transactions. This hostility is without solid foundation. Perhaps just as importantly, even if the hostility were legitimate, the proper means of regulating the nation's capital markets is through the securities laws, not through the back door using our tax laws.

In this connection, I cannot help but draw attention to the statement by the Committee issued in its public announcement of these hearings that "the revenue impact, if any, of the . . . options [being considered here today] is unknown." In other words, the purpose of all of these proposals is not to provide ways and means for the operation of the federal government, but rather to penalize, deter or do away with leveraged buyouts, mergers and acquisitions. If that is the purpose of this Congress, we would all be better off to achieve that purpose directly--rather than through ham-fisted attempts to manipulate the financial returns from these transactions.

That leveraged buyouts, mergers and acquisitions should be done away with or deterred, however, is a wrong-headed assumption in the first place.

One frequent refrain, for example, is that the substitution of debt for equity deprives the Treasury of income tax revenue. On this subject, I have been particularly interested to note the disagreement between two of my Harvard colleagues: Bill Andrews, who was my tax professor twelve years ago; and Michael Jensen, with whom I served on the faculty of the Harvard Business School.

Professor Andrews, in his testimony before the Senate Finance Committee, asserted that the government's tax take "is virtually sure to be far less" after an LBO. Like many academics, he attempts to prove the truth of this statement in theory, rather than by relying on data from the real world. Professor Jensen, on the other hand, in his testimony before this Committee, cited empirical studies which show that the Andrews subsidy argument ignores three important factors:

* First, while LBOs typically reduce a firm's corporate income tax immediately after the transaction, they also generate large offsetting revenue increases in the form of capital gains taxes paid by pre-buyout shareholders who are forced to realize all of the gain on their holdings.
* Second, the so-called subsidy argument also ignores the empirical evidence that after an LBO, a company's tax payments typically return to the pre-buyout level by the third year.

- Finally, Professor Jensen observes, there are always substantial income tax payments by the buyout firm creditors who receive the interest payments and must treat them as ordinary taxable income.

As a result, Professor Jensen concludes, in the case of an average buyout with a price of $500 million, the net effect on Treasury tax revenues is to increase them by approximately $110 million.

For those of you who would prefer to look at the U.S. Government's income statement rather than empirical studies by Harvard professors, I should point out that the LBO era has been one of substantially increased federal revenues from the corporate income tax. Beginning with 1983, the first year of the recovery, through the current fiscal year, it is estimated that revenue from corporate income taxes will have increased by more than $69 billion. That's a 189 percent increase. (During the same time period, revenue from individual income taxes increased 47 percent.)

Another spectre often raised in connection with leveraged buyouts is that jobs are lost when the new owners are forced to lay off workers in order to meet debt service requirements. This is a strange sort of flat-earth view of the economy, since the purpose of post-buyout management is to increase profitability by cutting costs, in the process making the company more efficient and more competitive. Does anyone seriously argue that less efficient companies with higher overhead make America more competitive internationally? If all of this leveraged buyout activity of recent years really had a materially adverse affect on employment, one would hardly expect to see America continuing with the longest peacetime economic expansion in our history, with the percentage of our population employed at an all-time high, and with the unemployment rate at a fifteen-year low.

In a study soon to be released by the National Bureau of Economic Research, Professors Brown and Medoff report that, "contrary to . . . public press coverage . . ., we find that wages generally grow faster following acquisitions . . . We also find employment grows faster."

The truth is that, beneath the thin veneer of concern for the continued efficient operation of our capital markets, there is a barely disguised contempt--or perhaps instead, jealousy--for those men and women who presently earn substantial incomes by virtue of their participation in acquisitions. The provisions in several of the proposals before this Committee that would penalize large mergers and acquisitions, but permit smaller ones, offer ample evidence of this emotional anti-wealth bias. Indeed, the triumph of populism over sound economics is most evident in those proposals that would impose tax penalties on so-called "excessive" compensation of those who work on leveraged buyout transactions.

One of the first things that all of us learn about capital markets is that they fluctuate. We have had down markets in the past, and we will have them in the future. When I first began as a corporate finance practitioner, the public offering market was all but dead. Year after year there was drought in the markets--and investment banking was not a very popular occupation for graduating MBAs. In those years, a peanut farmer from Georgia was urging this Committee to impose penalty taxes on so-called "windfall profits" in the energy industry.

Today, when the oil patch is hurting and Wall Street is in robust good health, many of the same people who brought us the ill-conceived windfall profits tax are urging these latest regulatory attacks on our economy. The attacks, however, ignore the fundamental relationship of risk and reward.

In fact, the small entrepreneur with a dream has no chance in America if the largest transactions are made uneconomical or are outlawed. The venture capital funds and institutional investors who might finance a very risky enterprise will do so only so long as there is at least some chance of spectacular reward. When discounted for risk, the spectacular reward is of course much more modest, and that is what distinguishes the ground floor or the mezzanine from the penthouse. Take away the spectacular rewards in those relatively few but always high-profile transactions, and you will eliminate the very incentives that make our free enterprise system work.

Let me offer a personal example. A health care company that I myself incorporated, and then brought through several rounds of venture capital financing and two public offerings, was eventually acquired by a large New York Stock Exchange company. That one time start-up venture now serves thousands of patients, and is worth in excess of $100 million; the individual investors have become multi-millionaires. That is not a typical case, but it illustrates the fallacy of attempting to discriminate against large transactions in a misguided effort to help the small entrepreneur.

Every single one of the entrepreneurs that I represented, and every one of the public offerings, mergers and acquisitions--and, yes, leveraged buyouts--that I handled, was undertaken in the hope of spectacular financial success. Those who bought common stock hoped that someday soon they might realize upon their investment through any number of means, including selling their shares in a tender offer, having their company acquired by a larger firm, or simply selling their shares in the public market to someone else who might generate his or her return in one of these ways.

By attacking debt financing of mergers and acquisitions, Mr. Chairman, we would be attacking those potential sources of investor return. That means that there will be fewer investors, and likewise fewer entrepreneurs who succeed in turning their dreams into reality.

I don't need to tell any of you that the most direct result of all of this would be fewer new jobs, fewer new products, and a decline in the wealth of the American people.

If we really wish to improve the workings of America's capital markets, we will choose not to make debt financing less attractive for American business. Instead, we will seek to make equity investment just as attractive as debt, by eliminating the double taxation of dividends and reducing the rate of tax on capital gains. As you know, Mr. Chairman, reducing the capital gains tax would generate a huge increase in federal revenues which would serve to offset any static revenue losses from a shareholder dividend credit. Restoring the intended economic benefits of equity ownership in this way would go far to eliminating the current disparity between asset values and share prices that is the principal attraction to arbitrageurs engaged in leveraged buyouts. It would address the real issue of how to make America more competitive by encouraging increased investment, savings, job creation, and wealth creation--instead of hobbling America's competitive position by increased taxation and regulation of our capital markets and the American men and women who participate in them.

Mr. **Dorgan**. Mr. Cox, thank you very much for your testimony. Mr. Schulze will inquire.

Mr. **Schulze**. Mr. Chairman, I have no questions other than to thank our colleague for his cogent presentation. He is right—we should encourage savings. I agree with almost all of his testimony, and appreciate his taking time to appear before us.

Mr. **Dorgan**. Mr. McGrath.

Mr. **McGrath**. Thank you, Mr. Chairman. I too have no questions.

I heartily agree with your testimony and wish you well. Thank you.

Mr. **Dorgan**. Mr. Sundquist.

Mr. **Sundquist**. Thank you, Mr. Chairman. My colleagues have expressed my opinion. We do appreciate our colleague taking time from his schedule to make these very important points. I agree with him also.

Thank you.

Mr. **Dorgan**. Mr. Brown.

Mr. **Brown**. Thank you, Mr. Chairman.

The witness, he brings an outstanding background to this subject, and we appreciate his taking the time to testify.

I would appreciate knowing your thoughts on the compensation packages that we see reported so prominently in Forbes and other magazines where, for example, compensation can run up to $10 million a year. Do you think the marketplace adequately regulates these packages?

Mr. **Cox**. I do not think there is much question that takeover activity in some instances acts as a marketplace discipline on management.

But let me address what I think is another aspect of your question: The stunning size of some of the fees that are earned in these transactions, and of some of the compensation that managers earn, either before or after one of these transactions.

Every single one of the small entrepreneurs that I represented, and every single person involved in the public offerings, mergers and acquisitions, and leveraged buyouts that I handled, undertook the risk in the hope of spectacular financial success. Now, spectacular financial success is by no means assured, and it is a rare transaction in which the spectacular financial success actually occurs; but when it does occur, it always is highly visible.

And all of those people who bought common stock in the transactions on which I worked always hoped that some day soon, they would be able to realize on their investment through any number of means—including selling their shares in a tender offer, having their company acquired, or perhaps simply selling their shares in a public offering to others who might realize their returns through one of these means.

The point is that mergers, acquisitions and LBO's are one way for the smaller entrepreneur who hopes to grow large eventually to realize upon his investment. By attacking the reward in large transactions, we are really directly attacking the incentives that bring the small entrepreneur into the system in the first place.

To put it another way, I am sure that Bill Cosby's salary is a major incentive for people to get into show business these days.

Mr. BROWN. Well, I appreciate the gentleman's observation, and I think his point of reference is sound. I guess the concern I have is not so much spectacular profits made out of stock options because it strikes me that has something to do with performance.

The concern I would have would be if this Congress made it much more difficult for shareholders to change management. And it strikes me if there is an abuse here, that the abuse is that we have made it so difficult for incumbent management to be challenged.

Mr. COX. I think that is 100-percent correct. One stick in the bundle of sticks, if you will, that constitutes the whole package of value in equity ownership is being able to exercise control over the corporation's affairs. Shareholders, as owners of the business, do need realistic control; they also need liquidity in their shares. They have got to be able freely to buy and sell their shares, and to vote them. The proposed tax on those fundamental elements of equity ownership is really an attack on the market itself—on the liquidity of the market, and on our ability to pool savings and investment to create jobs.

Mr. BROWN. I thank the gentleman, and yield back, Mr. Chairman.

Mr. DORGAN. Just a quick question, Mr. Cox.

The hood ornament on this wizard of new debt financing has been junk bonds or so-called high-yield bonds. And it is interesting that one individual was compensated, at least according to public reports, $550 million in 1 year as a result of fees accompanying the movement of these bonds.

Do you consider that something that gives you pause, or is that just good old healthy capitalism, seeing one person compensated $550 million in a year?

Mr. COX. Well, there are really two aspects of your question. One is the activity itself. We have more of it than we ought to——

Mr. DORGAN. I did not ask about that. I was asking about one individual's compensation of $550 million for the movement of junk bonds.

Does that give you a pause or does that just come under healthy capitalism?

Mr. COX. Well, as I said, some of the spectacular fees that are earned in these transactions which are, of course, not the norm, nonetheless attract a great deal of attention.

The important thing to remember is that every single person who makes a risk capital investment, and every single one of the people who assist him, is doing so in the hope of that spectacular financial award. Attack the top of the ladder, and you hit all of the people who are trying to climb on to the bottom rung.

Mr. DORGAN. But I am not sure I understand your answer.

Does it concern you, or do you think $550 million is just part of capitalism, and that is fine.

Mr. COX. Well, I must say that I detect in some of the proposals before this committee a contempt for those who are working in the merger and acquisition field—if not jealousy—that reflects is the same kind of mindset that led to the ill-conceived attacks on so-called windfall profits or obscene profits in the energy industry in the 1970's.

The fundamental relationship of risk and reward must always be kept in mind. We have got to remember that the markets are not always high, or liquid. We have got to remember that there have been long periods during which there was no market in which to make these kinds of deals.

Mr. DORGAN. You do not have any particular concern about that issue?

Mr. COX. Well, I am not suggesting that I, as a person operating in an arms-length environment as counsel to investors, or companies or counseling investment bankers would ever have structured a transaction so that one person made that amount of money.

Mr. DORGAN. But you are now operating in a field of public policy. You are not——

Mr. COX. Yes. If you asked me whether the Federal Government ought to intervene in those contractual negotiations so that the compensation received by people in arms-length transactions is different than would otherwise be achieved, I would say that would be bad public policy.

Mr. DORGAN. So, from a public policy standpoint, you think it is fine if one individual earns $550 million a year?

Mr. COX. It may well be that human beings make mistakes. But given my druthers, I would pick the judgment of the marketplace over that of the 435 of us.

Mr. DORGAN. The reason for my question, I am just trying to find out where the limits are on the parameters on either side of the issue here. And that was the reason.

Mr. Andrews.

Mr. ANDREWS. Just to follow up, I want to be sure I understand.

Please feel free to explain your answer, but yes or no, does it trouble you that someone makes a fee of over a half million dollars on one transaction?

Mr. COX. Definitely.

Mr. ANDREWS. Then please explain your answer, but does it trouble you, yes or no?

Mr. COX. I think we need to talk about the marketplace. That is what we need to focus on. By way of analogy, does it trouble you how much NBA players make? Does it trouble you how much rock stars make? That is the point.

The point is: do you want this Government to say that people in our country cannot make this much money because we are jealous of them? And I do not think that is the job of this body.

Mr. ANDREWS. Well, is your answer yes or is your answer no?

Mr. COX. I think you need to tell me: who we are talking about? What was the transaction? What did he do for it? Was it worth it.

In fact, it is conceivable to me that some things that some people can do in America are worth that amount of money. You have got to give me more specifics.

Mr. ANDREWS. Well, I think the line of questioning Mr. Dorgan is going after is some of these transactions on LBO's and some of the fees that were paid.

I think his question really is: Does it bother you from a public policy standpoint? Is this something that the Congress should bear watching that a person should make $500 million—and you personally, you are here to give us the benefit of your views this morning.

And I think his question really is: is it appropriate? Does it trouble you that someone makes $500 million on one single transaction?

I gathered from your answers that it does not, that your answer would be no, it does not trouble you.

Mr. McGRATH. Would the gentleman yield?

Mr. ANDREWS. I am not trying to be tough. I am just trying——

Mr. McGRATH. I just want to get the record straight here.

Are you alleging that the Milliken $550 million was from one transaction? It is my understanding that it was the compilation of transactions over a number of years.

Mr. Cox. Well, in any case, I would take it this is something of a hypothetical question, since we did not use real names and real transactions and so on.

Any time that marketplace which is supposed to be competitive generates what look to be larger than normal fees, earned, I think it makes sense for this body—and for all people who pay attention to markets—to inquire why? Is there something in the marketplace that is not working properly that is causing this to happen? Is there inefficiency?

From a purely objective standpoint, it is entirely proper to look at that symptom, if you will, to see if there is an underlying problem. And so, from an academic or objective standpoint, I have no trouble at all with our being attracted by that evidence to probe further and find out what is going on. And I think that is part of what is going on here. That is acceptable.

What is not acceptable is to say we are morally troubled that people in America make that much money—because those spectacular rewards, in fact, play a very significant role in the entire free enterprise system.

Mr. DORGAN. Mr. Cox, you make a very persuasive statement saying let the marketplace work no matter what almost. And I was trying to determine are there parameters to that? I mean are there excesses, are there certain areas of behavior that might trouble you? That was the purpose of the question.

Mr. Cox. By the way, implicit in my testimony, if not explicit—I hope it was explicit at least at some point—is that the marketplace is not presently being allowed to run free and unfettered.

There are enormous tax disincentives to paying dividends which make equity less attractive than debt in certain circumstances from an after-tax return standpoint. And I would very much like to see this committee focus on how to make equity investment more attractive by, one, reducing the rate of tax on capital gains and, two, eliminating the double taxation of dividends.

Mr. BROWN. Mr. Chairman, would you yield on that, point?

Mr. DORGAN. Happy to yield.

Mr. BROWN. Thank you, Mr. Chairman,

If you will permit me, I would just add an observation. I am concerned when I see enormous profits being made that appear to be coming not from a person's effort, but from a noncompetitive market situation.

If someone earned spectacular amounts of money due to their own efforts, why I say more power to them. If they make spectacular amounts of money due to governmental restrictions on competition that market system, then I think it is something that I am deeply concerned about. And I suspect the witness might be.

My perception is that part of the reason that we have compensation levels at times being out of proportion is because we have not allowed a competitive enough market system in terms of changing management. It seems to me that is a relevant factor here because the difficulty in changing management, leads to potential abuses in the compensation management receives.

Thank you, Mr. Chairman.

Mr. DORGAN. Mr. Sundquist, do you want to inquire?

Mr. SUNDQUIST. Thank you, Mr. Chairman, for yielding.

I would agree with what my colleague from Colorado said. I also want to clarify what Mr. McGrath said regarding Mr. Milliken's compensation and that the $550 million amount is not attributable to only one transaction.

I think as long as there are no abuses within the system, I would think—I am envious of Sam Walton being able to make the kind of money he makes, and I think that is the point that you are making is that in the free market that's what people who are entrepreneurs are striving for, is it not, as long as it's legal, within the bounds?

Mr. COX. Absolutely. The system of incentives, risks and rewards is what has thus far fueled our market. I would like to see that fuel poured on some more.

Mr. DORGAN. Mr. Cox, thank very much for your testimony this morning. We appreciate your coming.

Mr. COX. I would like to thank you very much for permitting me to testify, and to offer the research support of the Republican Task Force on Capital Markets for this committee whenever it needs it.

Mr. DORGAN. All right. Thank you very much.

The panel will next hear from Assistant Secretary of Tax Policy, John Wilkins, U.S. Department of Treasury.

Mr. Wilkins, would you please come to the dais. And the Chair would advise you that we want to have a complete discussion of your testimony.

Your entire testimony will be made a part of the permanent record. Summarize as you wish.

STATEMENT OF JOHN G. WILKINS, ACTING ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. WILKINS. Thank you very much, Mr. Chairman.

I am pleased to be here today to discuss the tax policy issues related to recent trends in mergers and acquisitions, leveraged buyouts, and corporate debt generally. Mr. Chairman, we commend the committee for the thoroughgoing nature of its examination of the issues raised by these trends.

We share the committee's concerns about LBO's and we continue to monitor carefully the levels and trends of such activity. However, as Secretary Brady stated earlier before this committee, we will not counsel at this time major tax changes to correct the trend which may be about to correct itself.

The evidence concerning LBO trends and impact is far from conclusive, and further study is clearly warranted. However, at present, we do not believe that major tax changes limiting interest deductions are justified, given other concerns I will discuss today.

We also note that the adverse effects described and many critics, particularly economic dislocations, are common to merger and acquisition transactions generally, not just to LBO's. In short, further study with a wider focus is appropriate, and that study is underway.

In our view, a focal point of these hearings should be the impact of the tax treatment of corporate debt and equity and on the competitiveness of U.S. businesses in world markets. That concern requires a tax policy focus considerably broader than the LBO financing issue. LBO's are symptomatic of a fundamental bias of the corporate income tax structure, which encourages debt financing and discourages equity financing of corporate assets. We are unique among the major industrialized nations that are our principal trading partners because we alone provide no relief for the double taxation of corporate equity.

In my testimony today, I will briefly review recent trends in corporate debt financing generally and in LBO's specifically; I will discuss potential impact of LBO's on competitiveness; I will evaluate the need for tax policy solutions to potential problems; and last, I will give the Treasury Department's view on some of the specific proposals listed for comment. All of those proposals are discussed in my written testimony.

Fueled by press reports of large transactions that substitute debt for corporate equity, many believe that corporate debt is reaching all-time highs. This impression is based upon measures of corporate leverage that do not take into account the large increases in the market value of corporations. These measures, which are based on book values rather than market values, indicate an increase in leverage over the past few years, with current levels at a historical high. This may be a substantial overstatement. While other measures, reflecting market values, also show an upward trend in recent years, they remain well below the peak level in the mid-1970s, and in line with the average over the last 20 years.

According to our estimates, the percent of the market value of nonfinancial-corporate assets represented by debt was 41 percent in 1988 and had remained between 35 and 40 percent from 1980 through 1987, averaging about 38 percent. This translates to a debt-to-equity ratio measured at market values of 0.7 to 1 in 1988. By contrast, the fraction of nonfinancial-corporate assets financed by debt in the decades of the 1970's averaged 40 percent and fluctuated between 31 and 47 percent. Clearly, current levels of debt financing are well under the highs of the 1970's. Moreover, there is as yet no hard evidence that LBO's are permanently increasing the amount of corporate debt in the aggregate.

The dollar value of corporate mergers and acquisitions completed in this country since 1981 has increased at the rate of just over 17 percent per year; however, over the last few years, there is evidence of some leveling off. In 1986, the total value of mergers and acquisitions reached $204 billion, but by 1988 the level of activity had grown to only $227 billion, a modest 5-percent annual average rate of growth over that 2-year period. Furthermore, the preliminary figures for the first quarter of 1989 show activity to be in the range of $195 billion at an annual level, well below the trend line.

Looking at recent history, the period of high LBO activity, there is no evidence that LBO financing has claimed a rising share of merger and acquisition activity. As a fraction of the total value of all mergers and acquisitions, LBO's have actually dropped from the 1986 high of 22.7 to 21.3 percent in 1987 and to 18.9 percent in 1988. Although the data for the first quarter of 1989, which are still preliminary, suggest a slight rise in the dollar value of LBO activity—to perhaps 20 percent—most of this activity results from deals that had already been planned and were in various stages of completion last year. In 1986, when LBO financing peaked as a share of the value of all completed mergers and acquisitions, we estimate that interest payments attributable to LBO's completed that year amounted to no more than 1 percent of all corporate interest deductions.

It is clear that the structure of our corporate income tax in which the income from equity capital is often taxed twice or more encourages debt over equity financing. This nonneutrality of the corporate income tax with respect to financing decisions is a potential source of inefficiency which, given the structure of our trading partners' tax systems, may be having a detrimental effect on American business as a global competitor.

On balance, it is unlikely that the increase in LBO activity during the 1980's has had a significant impact on revenues. But this conclusion is reached only after examining the various ways in which LBO's may affect Government revenue. Without passing judgment on a case-by-case basis, it can generally be stated that LBO's that increase efficiency will lead to more long-run tax revenue. Those that decrease efficiency will lead to less long-run tax revenue. Thus, the debate about long-run revenue turns on evaluations of long-run efficiency, which are, of necessity, case specific.

Although many experts dispute the conclusion that LBO's have been undertaken solely for tax reasons, it is clear that tax considerations have heavily influenced the structure of LBO transactions. Other factors which may determine whether a transaction will occur, as opposed to how it will be structured, include favorable interest rates, undervaluation by the market of assets or even entire divisions of companies, and possibly overdiversification of certain target corporations.

From a tax policy point of view, we believe a focus on LBO's per se, as I said, is too narrow, in that LBO's are merely one aspect of the general corporate tax bias against equity capital. Consequently, it is our position that any solution to perceived problems associated with LBO's should not be attempted through the tax code at this time. The tax code is too blunt an instrument and there is a real danger that any cure—particularly one that further increases the cost of capital to American corporate enterprise—may be worse than the perceived problem. If changes in the rules are appropriate, they are probably appropriate in other areas, such as securities and credit rules.

We are mindful, as is this committee, of the need to ensure that any tax legislation does not hinder the ability of U.S. corporations to compete in the global marketplace. Congress should weigh carefully whether proposals intended to restrict such activities will, in fact, have unintended adverse impacts on American business. For example, some of the options consider various limitations on the amount of interest corporations would be permitted to deduct. This approach could have a severe consequence for competitiveness. According to our estimates, for example, a 20-percent reduction in the amount of interest that could be deducted by corporations would cause an increase in the cost of capital of more than 6 percent for U.S. corporations. In the long run, the Nation's capital stock would be reduced by approximately 1 percent as a direct result of this. In current dollars, that is a reduction of $350 million in capital stock.

As I mentioned earlier, in contrast to our classical corporate income tax structure, which applies tax at both the corporate level and at the shareholder level, most other major industrialized countries provide some relief from the burden of the double taxation of dividends. In principle, this relief makes it easier for foreign firms to obtain corporate financing by increasing the after-tax return to investors.

Turning to interest, under current law, interest on corporate debt is generally deductible by the corporate payor as it is paid or accrued. In the case of a corporation as in the case of sole proprietors, interest expense is viewed as a cost of doing business and thus an appropriate deduction in determining net income subject to tax. There are a few exceptions to this rule. These limitations can be put into three categories: interest on debt that is more properly viewed as equity; interest on debt used to finance tax-favored income; and interest on current debt used to finance certain future income. These exceptions represent very special circumstances and have been put in the law for clear-cut policy reasons.

Limiting interest deductions would increase the cost of capital to American corporations and would hinder their efforts to compete globally. It could have adverse effects on the domestic economy. In addition, limits on the deductibility of interest on an acquisition-related debt could favor foreign acquirers to the extent that they would still be able to deduct interest payments in their home countries.

Limiting the deduction for interest paid would also increase significantly the tax liabilities for certain corporations in industries where a high degree of leverage is customary, such as public utilities, real estate, and finance. In the absence of special rules, this would be especially severe on financial institutions, which pay some 65 percent of all corporate interest. In addition, it would adversely affect small firms, start-up firms, and venture capital firms that can borrow only at high rates of interest.

Six of the nine options before this committee regarding changes in the tax treatment of interest payments deal generally with redressing the current bias against equity financing by limiting interest deductions. With one exception, relating to original issue discount, we would oppose these proposals for the reasons I have just stated. Also, these proposals would make it more difficult to get the fundamental reform of equity taxation that I suggest is needed down the road.

The other three options dealing with interest are aimed specifically at deterring LBO's. These proposals reflect the view that changes in the tax law should be made to specifically address LBO's. At this time we do not share that view.

One hybrid option I should mention would deny the deduction for all corporate interest by a specified percentage. The moneys so raised would be used to permit a deduction for the same percentage of dividends paid. The percentage would be determined on a revenue-neutral basis.

By limiting the corporate interest deduction, this proposal raises concerns similar to those raised by other proposals. In addition, corporations with characteristically above-average-debt ratios would be heavily penalized, and corporations that are predominantly equity financed would receive a windfall, as would their shareholders. One of the technical problems with this proposal is determining the revenue-neutral rates at which interest and dividends could be deducted. This would be extremely difficult. First, estimating behavioral responses on the part of investors and corporate managers would vastly complicate the calculation of a break-even percentage. Second, calculation of the revenue-neutral deduction percentage would depend on our ability to forecast accurately interest rates, debt levels, and dividend payments. The actual amounts for any of these variables would obviously differ widely from amounts forecasted at any moment in time. As a result, a disallowance ratio that is revenue neutral under current conditions could very easily raise or lose rather large sums of revenue under economic conditions prevailing in the future.

If it was a desire to maintain revenue neutrality, the deduction percentage would have to be adjusted on a regular basis. The percentages could be adjusted annually based on current forecasts. However, imposing such variability and uncertainty on a corporation's cost of capital would likely inhibit long-range planning and investment.

Even without considering these behavioral effects, the need to adjust the percentage deduction to maintain revenue neutrality over time can be illustrated by examining recent history. If this same proposal, designed to have a revenue neutral rate, had been set in the sixties, it would have been approximately 49 percent. That would be the break-even rate without behavioral changes. In the seventies, instead of 49 percent, it would have been 70 percent, 21 percentage points higher. Between 1980 and 1986, the revenue-neutral rate would have increased again, by another 8 percentage points, to 78 percent. It is a moving target. In sum, we do not believe this proposal is appropriate or needed at this time.

Mr. Chairman, another proposal I would like to focus on is the proposal denying the deduction for corporate interest expense on an original issue discount obligation issued in a transaction in which debt replaces equity until such time as amounts of interest were in fact paid. The proposal further suggests that this interest disallowance might apply only to OID obligations held by tax-exempt persons and foreign entities.

In general, Treasury believes there is a sound theoretical basis for allowing a current deduction for accrued but unpaid OID. In some cases, however, the assumptions underlying the OID rules do not necessarily apply and it may be inappropriate to accrue currently a deduction for unpaid interest. For example, the proposed

OID regulations do not generally provide for current deduction of contingent interest. Where there is a substantial risk of default, it may be more appropriate to treat the discount as contingent and not permit a deduction prior to payment. These concerns increase as the term of the bond increases. In addition, in certain cases, administrative concerns may argue against current accrual. These concerns are more likely to arise in longer term zero coupon bonds and bonds providing for payment in the form of a new bond, so-called payment in kind or PIK bonds.

Concerns about current deductibility of OID are particularly strong when the instrument is held by a tax-exempt organization or a foreign person, because the issuer has a current deduction for accrued OID, without an equivalent current cash payment, and the holder has no corresponding income inclusion. In the case of OID, current law already reflects this concern on obligations issued to related foreign persons. No deductions are allowed on such obligations until interest is actually paid.

The proposal also suggests limiting the nondeductibility rule to debt that replaces equity. While debt replacing equity tends to erode the corporate tax base, taxing only such debt suggests that all corporations are free to establish whatever capital structures they choose, but once they have made their choice, they have pledged not to change the structure if the change decreases their corporate tax liability. In other words, a newly organized corporation would be able to treat its interest deductions more favorably than a corporation wishing to recapitalize.

In sum, we agree that certain applications of the OID rules merit further consideration because of the ability of issuers to exploit the rules. Any change in the treatment of the issuer, however, should also carefully consider how to treat the debtholder.

Mr. Chairman, turning to dividends, another set of options would modify the tax treatment of dividends. Under current law, corporations are generally treated as taxpaying entities separate from their shareholders. A corporation separately reports, and is directly taxable on, the equity holders' share of income. The after-tax income of a corporation is not taxable to its shareholders until it is distributed to them. Dividends paid by corporations other than S corporations are taxed to individual shareholders as ordinary income. Consequently, as I said before, corporate taxable income paid as dividends to individuals generally bears two taxes, the corporate income tax and the individual income tax.

This different tax treatment of debt and equity in the corporate sector creates economic distortions. It distorts decisions regarding a corporation's capitalization and its policies with regard to investment and distribution of earnings in ways that detract from the efficiency of the economy. The double taxation of dividends encourages corporations to finance their operations with debt rather than equity. The double taxation of dividends also increases the cost of capital for corporations and thereby discourages capital-intensive means of production in the corporate sector. Similarly, it penalizes goods and services that are more readily produced or provided by the corporate sector and the performance of risk-pooling functions that are most effectively accomplished by corporations. Investors are thus discouraged from using the corporate form even in circumstances where nontax considerations make the corporate form desirable.

The LBO phenomenon has focused attention on the bias in our tax system against equity capitalization and has renewed interest in proposals that would provide partial relief from multiple taxation of corporate earnings. As I stated earlier, most of our major trading partners already provide some form of relief from the multiple taxation of corporate earnings.

Proposals for relief from the burden of multiple taxation of corporate earnings have substantial merit quite apart from the recent considerations related to LBO's. We recognize, however, that revenue considerations limit Congress' ability to provide such relief at this time. The fact that we cannot currently afford to grant such relief, however, should not obscure its desirability as a matter of sound tax policy.

Both the dividends paid deduction and the shareholder credit, two options under consideration, can be designed to deal with the special problems. The dividends paid deduction has the advantage of simplicity in that it does not directly affect the computation of the shareholders' tax liability; it does not provide as much flexibility as a credit, however. If it is determined that relief should be denied to certain dividend recipients, such as nonresident shareholders in the U.S. corporations, the shareholder credit approach may be preferable because of its flexibility in this regard.

Other options before this committee includes options that affect fees, investment banking fees and other LBO advisory fees. While the fees earned in connection with LBO transactions are clearly substantial, and we believe it is appropriate to tax such fees, we believe it is inappropriate to tax such fees in a punitive manner. The appropriate level of fees should be set by the marketplace. If fees being charged to the parties in these transactions are too large, competition should bring them down.

Another proposal is designed to discourage arrangements that raise serious conflict of interest concerns. We share the concerns that underlie this proposal, and we believe that serious study should be given to addressing them, either under the Federal securities law or State corporation laws. Because these concerns are not tax-related, however, we feel it is inappropriate to address them through the Tax Code.

Turning to options relating to the tax treatment of foreign persons and to issues of foreign investment, in our view the dominant issue is the extent to which the obligations of the United States under its many existing tax treaties should be respected. The Treasury wishes to reiterate its general objection to any override of tax treaties. Treasury objects to override not merely because it violates our international commitments, but also because it is, in most cases, inconsistent with the U.S. long-term economic and political interests.

Our tax treaties, as you know, Mr. Chairman, are not unilateral concessions to the interests of foreign persons investing in the United States. They represent a careful balance of interests and confer substantial benefits on many U.S. persons investing overseas.

Another set of proposals before the committee deals with the tax treatment of good will. Under the first alternative, taxpayers would be allowed to amortize the good will in the target corporation over a 40-year period if the basis of such good will were stepped up as the result of a taxable acquisition of the target.

Under the second alternative, U.S. treaty policy would be reviewed to determine whether foreign acquirers are given an advantage over U.S. acquirers related to the tax treatment of good will and acquisitions.

Foreign corporations may have an advantage over U.S. corporations in asset acquisitions because the foreign corporations may be permitted a deduction in their home jurisdictions for the amortization of the cost of good will. It is our understanding, however, that acquisitions of substantial U.S. business assets as opposed to stock acquisition are not common in most industries. We are not aware of any foreign jurisdiction that permits its corporations to amortize good will for tax purposes when the acquisitions are through stock sales.

The treatment of good will for financial accounting purposes may also disadvantage U.S. corporations relative to their foreign counterparts. Because some countries do not require that good will be amortized for financial accounting purposes, foreign acquirers may have an artificial advantage in the competition for investors. Treatment of good will for financial purposes is not, however, a problem that can be addressed through the tax laws.

Completely apart from concerns over foreign competition, there remains, Mr. Chairman, the issue of whether we should permit the amortization of purchased good will. An argument can be made that the purchase value of good will does dissipate over time. In other words, the value of good will acquired on the acquisition date steadily declines and additional costs incurred in sustaining the business go toward the development of new or replacement good will. Thus, under present law, taxable income under this theory is overstated relative to economic income by the amount of the current-year decline in the value of the intangible asset.

Were good will to be viewed as a wasting asset, its acquisition cost should be amortized over its useful life. In fact, it's very difficult to determine the useful life of an asset. So it would be appropriate to fix by statute the period over which this asset should decline. For financial accounting purposes, the acquisition cost of an asset in the nature of good will must be amortized over the useful life but it is not to exceed 40 years. Thus, 40 years might be the appropriate time period for the treatment of good will in the Tax Code. It is likely that such a provision, if introduced into the Tax Code, would, however, result in a large revenue loss.

Another option before the committee would reestablish a capital gains preference for certain assets. This option would provide a 50-percent exclusion for gains from the sale of an asset which is financed through corporate or individual equity and held for at least three years. While we support long-term capital gains incentives, we believe this proposal is probably not as suitably structured as the President's capital gains proposal.

Last, I would like to address several options restricting the use of ESOP's. ESOP's are used both in LBO transactions and to defend against potential takeovers. In an LBO transaction, an ESOP may be used to take a company private and create a company that is entirely employee owned. Alternatively, an ESOP may be one of the several players in an LBO, as, for example, where a management group takes the company private and establishes an ESOP as one source of financing. In either case, the various tax benefits for ESOP's may play a significant role in reducing the costs of the transaction.

ESOP's are also frequently established as a defensive tactic to protect against unwanted takeovers or LBO's. This is accomplished by establishing an ESOP that acquires a significant portion of voting stock, thus placing a significant number of voting shares in the hands of employees, who it is presumed, will vote against a hostile tender offer, thus making it more difficult for a raider to acquire a significant number of shares to consummate the transaction.

While the administration is committed to encouraging meaningful employee stock ownership through the ESOP mechanism, the Treasury Department does believe that the committee should consider whether some of the newer tax preferences afforded to ESOP's, including the interest exclusion for ESOP loans, the deduction for dividends paid with respect to ESOP securities, and the nonrecognition of gain on sales of stock to ESOP's, are appropriate. The Treasury Department believes that these new tax benefits afforded to ESOP's may not be justified either by the role of ESOP's as retirement plans or their aggregate effect on corporate performance, and that further study, the appropriateness of these additional tax benefits should be undertaken.

While we would oppose any reduction in legitimate incentives for meaningful employee stock ownership, we urge the committee to be vigilant against the potential for abuse.

In conclusion, Mr. Chairman, we at Treasury intend to continue to monitor LBOs. The conclusions we expressed today reflect our view that the economic evidence currently available does not justify major steps such as limiting interest deductions. We are particularly concerned that such actions, once taken, may themselves become an impediment to future corporate tax reform to reduce the bias against corporate equity investment.

Fundamental change in the corporate tax system should come only after careful study and after workable and stable methods of financing such change have been devised.

We intend to continue a constructive dialog with the Congress to develop proposals which will result in long-run improvements to the corporate tax system.

Mr. Chairman, that concludes my formal statement. I will be happy to answer any questions you or members of the committee may have for me.

[The statement of John G. Wilkins follows:]

For Release Upon Delivery
Expected at 10:00 a.m.
May 16, 1989

STATEMENT OF
JOHN G. WILKINS
ACTING ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss tax policy issues related to recent trends in mergers, acquisitions, leveraged buyouts, and corporate debt generally. We commend the Committee for the thorough-going nature of its examination of the issues raised by these trends.

We share the Committee's concerns about LBOs, and we continue to monitor carefully the level and trends of such activity. However, as Secretary Brady stated earlier before this Committee, we will not counsel major tax changes to correct a trend which may be about to correct itself. The evidence concerning LBO trends and impact is far from conclusive and further study is clearly warranted. At present, we do not believe that major tax changes limiting interest deductions are justified given other concerns I will discuss today. We also note that the adverse effects described by many critics--particularly economic dislocations--are common to merger and acquisition transactions generally, not just LBOs. In short, further study with a wider focus is appropriate and that study is underway.

In our view, a focal point of these hearings should be the impact of the tax treatment of corporate debt and equity on the competitiveness of U.S. businesses in world markets. That concern requires a tax policy focus considerably broader than the LBO financing issue. LBOs are symptomatic of a fundamental bias of the corporate income tax structure, which encourages debt financing and discourages equity financing of corporate assets. We are unique among the major industrialized nations that are our principal trading partners because we alone provide no relief for double taxation of corporate equity.

I. INTRODUCTION

In testimony today I will briefly review recent trends in corporate debt financing generally and in LBOs specifically; I will discuss potential impacts of LBOs on competitiveness; I will evaluate the need for tax policy solutions to potential problems; and, last, I will give the Treasury Department's views on the specific proposals listed for comment.

Recent Trends in Corporate Finance

Fueled by press reports of large transactions that substitute debt for corporate equity, many believe that corporate debt is reaching all-time highs. This impression is based upon measures of corporate leverage that do not take into account the large increases in the market value of corporations. These measures, which are based on book values, indicate an increase in leverage over the past few years, with current levels at an historical high. This may be a substantial overstatement. While other measures reflecting market values also show an upward trend in recent years, they remain well below the peak levels in the mid-1970s and in line with the average over the last 20 years.

According to our estimates, the percent of the market value of nonfinancial corporate assets represented by debt was 41 percent in 1988 and had remained between 35 percent and 40 percent from 1980 through 1987, averaging 38 percent. This translates to a debt to equity ratio measured at market values of .7 to 1 in 1988, and an average of .62 to 1 from 1980 through 1987. By contrast, the fraction of nonfinancial corporate assets financed by debt in the decade of the 1970s averaged 40 percent (or a debt to equity ratio of .65 to 1), and fluctuated between 31 percent and 47 percent (or .45 to .89 to 1 for the debt to equity ratio). Clearly, current levels of debt financing are well under the high levels during the 1970s. Moreover, there is as yet no hard evidence that LBOs are permanently increasing the amount of corporate debt in the aggregate.

According to the publication Mergers and Acquisitions, the dollar value of corporate mergers and acquisitions completed in this country since 1981 has increased at the rate of just over 17 percent per year; however, over the last few years, there is evidence of some leveling off. In 1986 the total value of mergers and acquisitions reached $204 billion but by 1988 the level of activity had grown to only $227 billion, a modest 5 percent average annual rate of growth. Furthermore, the preliminary figures for the first quarter of 1989 show activity to be in the range of $195 billion, well below the trend line.

Looking at recent history, the period of high LBO activity, there is no evidence that LBO financing has claimed a rising share of merger and acquisition activity. As a fraction of the total value of all mergers and acquisitions, LBOs have dropped from a 1986 high of 22.7 percent to 21.3 percent in 1987 and to 18.9 percent in 1988. Although the data for the first quarter of 1989, which are still preliminary, suggest a slight rise in the dollar share of LBO activity -- to around 20 percent -- most of this activity results from deals that were planned and in various stages of completion last year. (These figures do not include the $25 billion RJR Nabisco transaction because it was not formally completed until April 1989.) In 1986, when LBO financing peaked as a share of the value of all completed mergers and acquisitions, we estimate that interest payments attributable to LBOs completed that year amounted to no more than 1 percent of all corporate interest deductions. This calculation is apt to err on the high side because the definition of an LBO used here is any private acquisition of a public corporation that used debt as well as equity in the purchase agreement and not just highly leveraged financial arrangements.

Tax Influences

It is clear that the structure of our corporation income tax in which the income from equity capital is often taxed twice or more -- once when income is earned by the corporation and again at the individual tax level when distributions are made in the form of dividends and possibly again when intercorporate distributions are made -- encourages debt over equity financing. This non-neutrality of the corporate income tax with respect to financing decisions is a potential source of inefficiency which, given the structure of our trading partners' tax systems, may be having a detrimental effect on American business as a global competitor.

On balance, it is unlikely that the increase in LBO activity during the 1980s has had a significant impact on revenues. This conclusion is reached only after examining the various ways in which LBOs may affect government revenue. Without passing judgment on a case-by-case basis, it can generally be stated that LBOs that increase efficiency will lead to more long-run tax revenue and that LBOs that decrease efficiency will lead to less long-run tax revenue. Thus, the debate about long-run revenue turns on evaluations of long-run efficiency, which are, of necessity, case specific.

The elements of a typical LBO financing arrangement and the way that they affect tax revenues are as follows:

Capital gains from the sale of corporate shares by existing owners are prompted by the buyout offer and often reflect a higher price and hence increased capital gain revenues. Tax-exempt owners, such as pension funds, of course, pay no current capital gains tax from the sale; however, taxable owners pay a capital gains tax sooner than they otherwise would.

Interest income of debt holders generates additional tax revenue to the extent that LBO debt pays a higher yield than the debt holders would have received on alternative investments. Again, however, revenue is lost to the system to the extent the higher yield is paid to tax-exempt entities.

Interest deductions from the corporate profits base will generally reduce corporate tax revenues by more than the additional tax from interest income of debt holders because corporate income tax rates now generally exceed individual income tax rates and because tax-exempt and tax-favored entities hold a substantial amount of corporate debt.

Corporate profits and the corporate income tax on them would rise to the extent that the sum of the parts of the original corporation are more efficiently managed under the post-LBO scenario.

Capital gains at the corporate level from the subsequent disposition of certain corporate assets typically sold in order to help service the LBO debt will raise corporate level tax revenue by the degree to which the sale of such assets occurs sooner under the post-LBO scenario.

Dividend income and the associated individual income tax are reduced as corporate earnings are typically devoted to servicing higher levels of LBO debt.

Because the weight given to each of these revenue factors differs with each LBO transaction, it is impossible to generalize as to the overall impact of LBOs on taxes. A revenue analysis would have to be conducted on a case-by-case basis and would have to extend far into the future to capture important long-run effects.

Although many dispute the conclusion that LBOs have been undertaken for tax reasons, it is clear that tax considerations have heavily influenced the structure of LBO transactions. Other factors which may determine whether a transaction will occur (as opposed to how it will be structured) include favorable interest rates, undervaluation by the market of assets and even entire divisions of companies, and possibly over-diversification of certain target corporations.

The Tax Reform Act of 1986 contained a number of provisions that altered the relationship between debt and equity financing. The inversion of the traditional ranking of the top individual and top corporate income tax rate in and of itself probably encourages more debt financing of corporate assets. This is because interest deductions at the 34 percent marginal corporate income tax rate are worth relatively more when the highest individual income tax rate applicable to returns on distributed equity investments is 28 percent or 33 percent than when the corporate rate was 46 percent and the top individual rate was 50 percent. On the other hand, sharply lower corporate and individual income tax rates since 1986 reduce the overall impact of the tax system on all transactions.

The impact of full taxation of capital gains under the 1986 Act on LBO transactions is also unclear. Full taxation of gains made equity investments less attractive to individual investors but also may have discouraged purchase transactions generally because such transactions trigger immediate capital gains realizations by taxable owners.

Good Debt and Bad Debt

It is both difficult and dangerous to try to distinguish good debt from bad debt, good LBOs from bad LBOs, and good mergers from bad mergers using a tax policy standard.

Observers generally identify "bad" LBOs after the fact by examining the consequences the financing arrangement had on corporate employment, on the amount and use of cash flow, and on other stakeholders such as "the community of corporate neighbors." In contrast, however, if an LBO results in improved efficiency, there may be transitional unemployment as labor and capital move from less efficient activities to more efficient activities. Although this would produce short-run dislocations, which would be a cause of concern, it would be offset by general improvement in the economy in the long run.

From a tax policy point of view, we believe a focus on LBOs per se is too narrow in that LBOs are merely one aspect of the general corporate tax bias against equity capital. Consequently, it is our position that any solution to perceived problems associated with LBOs should not be attempted through the tax code at this time. The tax code is too blunt an instrument and there is a real danger that any cure -- particularly one that further increases the cost of capital to American corporate enterprise -- may be worse than the perceived problem. If changes in the rules are appropriate, they are appropriate in other areas, such as securities and credit rules.

Competitiveness

We are mindful, as is this Committee, of the need to ensure that any tax legislation does not hinder the ability of U.S. corporations to compete in the global marketplace. Congress should weigh carefully whether proposals intended to restrict such activities will, in fact, have unintended adverse effects on American business and the American economy. For example, some options consider various limitations on the amount of interest corporations would be permitted to deduct. This approach could have a severe consequence for competitiveness. According to our estimates, a 20 percent reduction in the amount of interest that could be deducted by corporations would raise the cost of capital for U.S. corporations by more than 6 percent. In the long run, the nation's capital stock would be reduced by approximately 1 percent, or $350 billion.

In contrast to our classical corporate income tax structure, which applies tax at both the corporate level and at the shareholder level, most other major industrialized countries provide some relief from the burden of the double taxation of dividends. In principle, this relief makes it easier for foreign firms to obtain corporate financing by increasing the after-tax return to investors.

Many countries provide relief by giving the shareholder a tax credit for all or part of the corporate tax paid, in effect treating that part of the corporate tax as if it were merely a withholding of tax on the shareholder. The shareholder adds the credit to taxable income and then credits an equal amount against his or her individual income tax due.

Eight of the 12 European Community member countries use such an approach, as do Canada, Japan, Australia, New Zealand, and Finland. In Germany, Italy, Australia, and New Zealand, double taxation is completely eliminated by allowing the shareholder to receive credit for the full tax paid by the corporation. Several other countries substantially reduce double taxation; for example, in Belgium, France, Ireland, and the United Kingdom, the shareholder credit amounts to at least half the corporate tax. In Japan and Spain, the credit amounts to 10 percent of the dividends received.

A less frequently used alternative method provides relief for the double taxation of dividends at the corporate level by subjecting distributed profits to a lower rate of tax than retained profits. This approach is used by Germany and Japan, which combine this approach with a shareholder-level credit, and by Greece and Norway. In Germany, for example, the corporate rate of 56 percent on retained profits is reduced to 36 percent on distributed profits. The 36 percent rate is then fully credited to the shareholder, eliminating double taxation of distributed dividends. Japan currently taxes retained profits at 40 percent and dividend distributions at 35 percent. In addition, shareholders receive a tax credit for 10 percent of dividends received. However, beginning in 1990, Japan will replace its split rate tax with a single rate of 37.5 percent.

II. OPTIONS MODIFYING THE CURRENT TAX TREATMENT OF CORPORATE INTEREST

Current Law

Under current law, interest on corporate debt is generally deductible by the corporate payor as paid or accrued. In the case of a corporation as in the case of a sole proprietor, interest expense is viewed as a cost of doing business and thus an appropriate deduction in determining net income subject to tax. Consequently, the corporate interest deduction is currently limited in only very special circumstances and for clear-cut policy reasons. These limitations can be divided into three categories: (1) interest on "debt" that is more properly viewed as equity; (2) interest on debt used to finance tax-favored income; and (3) interest on current debt used to finance certain future income. Many of these limitations apply to individuals as well as to corporations.

Debt More Properly Viewed as Equity

Section 279 is a provision that limits the corporate interest deduction for debt that is more properly viewed as equity. It disallows interest deductions on certain indebtedness incurred to acquire another corporation's stock or at least two-thirds of its assets. This disallowance applies only to interest in excess of $5 million and only if: (1) the debt is substantially subordinated and carries an equity participation, such as being convertible or including warrants to purchase stock; and (2) the issuer has a debt/equity ratio that exceeds two to one or has annual earnings that do not exceed three times annual interest costs.

Section 385 is a grant of regulatory authority for the Treasury to determine whether an interest in a corporation is to be treated as stock or debt. The statute lists five factors that may be included in making this determination, including whether there is a written unconditional promise to pay a sum certain on a specified date, whether there is subordination, and the debt to equity ratio of the corporation. Although section 385 was enacted in 1969, to date no satisfactory general rules have been developed under this provision. The Internal Revenue Service has administered this area on a case-by-case basis by examining all the characteristics of a particular instrument in determining whether it is more properly treated as debt or equity for federal income tax purposes.

Debt Financing Tax-Favored Income

Section 265(a)(2) denies an interest deduction on indebtedness incurred or continued to purchase or carry tax-exempt income. Under section 265(a)(2), the deduction is disallowed only if there is a connection between the indebtedness and the acquisition or holding of the tax-exempt obligation. Section 265(a)(2) is intended to prevent the double benefit of both earning tax-free income and deducting related interest expenses.

Section 246A limits the dividends received deduction if the investment in the stock is directly attributable to indebtedness. The regulatory authority under this section provides for the disallowance of interest deductions in lieu of reducing the dividend received deduction where the obligor is someone other than the corporation receiving the dividend. This provision prevents a double benefit from the interest deduction and the dividends received deduction.

Debt Financing Future Income

For costs incurred in manufacturing or constructing certain tangible property, section 263A requires that interest paid or incurred during the production period be capitalized. Interest is allocable to the production of property not only if it can be traced specifically to production, but also where the taxpayer could have avoided the interest expense if amounts applied to production expenditures could have been used to repay debt. These interest capitalization rules are intended to avoid a mismatching of income and expense, and capitalized interest is, in effect, deductible when the related income from the property is realized. Similarly, section 263(g) requires the deferral of the deduction for interest allocable to personal property that is a part of a straddle until such property is sold and associated gains are realized.

Despite these various limitations, interest paid or accrued by corporations continues for the most part to be deductible. Accrued interest deductible by corporations includes original issue discount. Since mid-1982, taxpayers that issue debt with original issue discount have been required to compute the deduction of original issue discount on a constant yield basis over the life of the debt instrument. In the case of zero coupon instruments, OID thus accrues in steadily increasing amounts over the term of the obligation. In addition, the OID rules require symmetry: Cash basis as well as accrual taxpayers must include OID in income as the interest accrues. This income inclusion, however, is largely an academic requirement since tax-exempt and tax-favored entities (such as insurance companies) are the principal purchasers of deep discount or zero coupon bonds.

Discussion

The tax bias against equity under current law could be greatly reduced either by providing some form of tax relief for equity distributions or by limiting the deductibility of interest expense. These approaches, however, raise very different policy issues. Before turning to comments on specific options that would limit interest deductions, I would like to review some of our general concerns about proposals of this type.

Most important, limiting interest deductions would increase the cost of capital to American corporations and thus hinder their efforts to compete in the global economy. It would have adverse effects on the domestic economy. In addition, limits on the deductibility of interest on acquisition-related debt would favor foreign acquirers to the extent they are able to deduct interest payments in their home countries.

Limiting the deduction for interest paid would also increase significantly the tax liabilities for corporations in industries where a high degree of leverage is customary, such as public utilities, real estate, and finance. In the absence of special rules, this effect would be especially severe on financial institutions, which pay some 65 percent of all corporate interest. In addition, it would adversely affect small firms, start-up firms, and venture capital firms that can borrow only at high rates of interest.

A limitation on corporate interest deductions would discourage use of the corporate form. Any further disadvantage to the use of the corporate form requires particularly careful consideration given the fundamental changes made by the 1986 Tax Reform Act. Before the 1980s, certain tax rules mitigated the impact of the separate tax on equity income. Returns on equity were taxed at the corporate level at rates below individual rates (at times markedly so), and the second level of tax on the distribution of income from corporate equity to shareholders could be deferred by retaining earnings and ultimately minimized through a sale of stock taxed at preferential capital gain rates. The rate inversion introduced by the 1986 Act, and the repeal of the capital gain preference, the dividend exclusion, and the General Utilities doctrine, have reduced or eliminated these compensating factors that formerly ameliorated the impact of the separate tax on corporate equity income.

Restricting the deduction for interest paid would also raise issues with respect to the treatment of interest substitutes. If the deduction of interest were limited, corporations would have additional incentives to lease assets and deduct rental payments rather than borrow to finance a purchase of the assets. A portion of such rental payments would represent implicit interest.

Six of the nine options before this Committee regarding changes in the tax treatment of interest payments deal generally with redressing the current bias against equity financing by limiting interest deductions. With one exception, relating to the current accrual of original issue discount, we would oppose these proposals for the reasons stated above.

The other three options are aimed specifically at deterring LBOs. These proposals reflect the view that changes in the tax law should be made to specifically address LBOs. We do not share that view.

Comments on Specific Options

Deny Interest Deduction and Require Recognition of Gain at the Corporate Level For Hostile Acquisitions (Option B-1)

This proposal would deny the interest deduction for debt incurred in a hostile tender offer, defined as an offer disapproved by a majority of the independent members of the target's board. In a hostile stock acquisition, the proposal would also require recognition of all gain at the corporate level.

It is by no means clear that hostile LBOs, as a general matter, are any less likely to be beneficial than friendly ones. A hostile LBO can just as readily increase efficiency and productivity as a "friendly" transaction. Moreover, tax rules designed to discourage hostile takeovers would clearly serve to entrench management.

The proposal also poses administrative and definitional difficulties. A board of directors' determination that a takeover is or is not acceptable is frequently a highly complex and dynamic process. The effect of this proposal would also be to bring new and extreme pressure to bear on the decisionmaking of independent directors.

None of the perceived problems associated with hostile acquisitions is caused by current tax rules. Accordingly, we would oppose attempts to address any such problems through changes in the tax code at this time.

Deny Interest Deduction for Acquisitions Not in the Public Interest (Option B-2)

Under the proposal, the Federal Trade Commission (FTC) would determine whether a proposed merger would have a substantial adverse effect on employment. If the FTC makes such a finding, the merger would be deemed not to be in the public interest and the corporate deduction for interest on debt used to finance the merger would be disallowed.

This proposal uses the tax code to address non-tax policy concerns, and we would object to it on that basis. Furthermore, it is not clear how the FTC would be able, in any realistic way, to make the findings that would trigger the proposed nondeductibility, either before or after a takeover. The effect of a change of control on employment depends on a variety of factors, many of which cannot be predicted or anticipated. It should also be noted that the proposed standards for FTC review are biased: They appear to exclude consideration of the benefits derived from shutting-down obsolete or otherwise inefficient operations. For ~~example, a~~ merger that produced short-term unemployment could lead to long-term increases in employment, but would presumably fail the proposed test.

Deny Interest Deductions on High-Yield Debt (Option B-3)

The proposal would deny the deduction for interest payments on so-called "junk bonds" above a specified dollar amount, such as $50 million. It would define a junk bond by reference to one or more of several characteristics, including interest rate, subordination, convertibility and rating.

So-called "junk bonds" can serve an important and legitimate role in the financing of corporate activity. Increasing the cost of their use could restrict access to capital markets for many firms and raise the cost of capital to others. It would hurt issuers of high-risk bonds, including small firms, start-up firms, and venture capital companies that have difficulty raising funds in other ways. If the problem identified is LBOs, a proposal aimed at junk bonds, which are used in some LBOs but not others and which are used for purposes other than LBOs, is not well targeted.

This comment should not be read to imply a lack of concern about risks inherent in high-yield bonds. Existing LBOs and the junk bonds used to supply the debt capital through which they are financed have thrived in a period of extended economic expansion. Under such a favorable economic environment, some investors may not have sufficiently understood the risks of junk bonds in the event of a downturn in the economy. While older studies have found the default rate for junk bonds to be low, a more recent study that tracked junk bonds over time shows default rates to have been substantial, even when the economy was strong. This study does not, however, analyze the costs of defaults nor does it analyze whether investors are adequately compensated for the greater risk inherent in junk bonds by higher returns. Ultimately, however, these are corporate finance, not tax, issues that are best addressed through the securities laws.

Reduce Corporate Interest Deductions to Permit a Dividends Paid Deduction on a Revenue-Neutral Basis (Option B-4)

The proposal would deny the deduction for all corporate interest by a specified percentage. The money so raised would be used to permit a deduction for the same percentage of dividends paid. The percentage would be determined on a revenue-neutral basis.

By limiting the corporate interest deduction, this proposal raises concerns similar to those raised by other such proposals. In addition, corporations with characteristically above-average debt ratios would be heavily penalized, and corporations that are predominantly equity financed would receive a windfall, as would their shareholders.

Determining revenue-neutral rates at which interest and dividends could be deducted would be very difficult. First, estimating behavioral responses on the part of investors and corporate managers would vastly complicate calculation of a break-even percentage. Second, calculation of the revenue-neutral deduction percentage would depend on our ability to forecast accurately interest rates, debt levels, and dividend payments. The actual amounts for any of these variables could differ widely from the amounts forecasted. As a result, a disallowance ratio that is revenue neutral under current economic conditions would be likely either to raise or to lose revenues under economic conditions prevailing in the future.

In order to maintain revenue neutrality, the deduction percentage would have to be adjusted on a regular basis. The percentages could be adjusted annually, based either on current forecasts or on actual data on dividends and interest payments from a prior year. Imposing such variability on a corporation's cost of capital, however, would likely inhibit long-term planning and investment.

Even without considering behavioral effects, the need to adjust the deduction percentage to maintain revenue neutrality over time can be illustrated by examining historical data. If the revenue-neutral rate had been set in the 1960s, it would have been approximately 49 percent. In the 1970s, it would have been 70 percent, 21 percentage points higher. Between 1980 and 1986, the revenue-neutral rate would have increased again, by an additional 8 percentage points, to 78 percent.

The proposal also raises technical issues, such as the interaction of the dividends paid deduction with the dividends received deduction for corporations, the treatment of tax-exempt and foreign shareholders, and other issues that arise in connection with proposals for dividend relief. Such issues are addressed in the following section in the discussion of dividend relief proposals.

Repeal Deduction for Corporate Interest Expense and Provide Shareholder Credit on Dividends (Option B-5)

This proposal would deny any deduction for corporate interest expense. Shareholders would receive a credit for corporate taxes paid on earnings distributed as dividends.

Rather than equalizing the treatment of debt and equity, this proposal would turn current law on its head by taxing earnings distributed as interest twice -- once when earned by the corporation and once when received by the debtholder -- and earnings distributed as dividends only once (at the corporate level). A shareholder-level credit with respect to distributed earnings raises issues that will be discussed in the section below relating to equity relief proposals.

The complete repeal of the deduction for corporate interest highlights issues raised by all proposals that limit corporate interest deductions: increasing the cost of capital, favoring the non-corporate sector, increased pressure on distinguishing debt from equity instruments, and the need to identify interest analogs such as rents or royalties. Because this proposal denies all corporate interest deductions, it also exacerbates transition-related problems. The proposal could, for example: (a) dramatically increase corporate tax collections and correspondingly threaten the financial stability of many corporations; (b) cut dividend payments (and personal tax collections) during the interim while corporations restructure by replacing "debt" with "preferred stock"; and (c) precipitate a restructuring of the investment portfolios of tax-exempt organizations. While these and other concerns could be reduced by substantial transition relief, there does not appear to be a tax policy justification for this proposal that is sufficiently compelling to warrant its enactment.

Disallow Corporate Interest Deduction in Excess of a Specified Rate of Interest (Option B-6)

The proposal would deny in whole or in part the deduction for corporate interest paid in excess of some specified percentage above the applicable federal rate (AFR). This partial interest disallowance would not affect the characterization of the instrument as debt.

This approach is apparently based on the assumption that an unusually high interest rate indicates that a purported debt obligation is really "disguised equity." Under this view, a high interest rate indicates a high degree of risk, which is usually associated with equity holdings. It is undeniable, however, that many obligations traditionally viewed as debt also carry substantial risk. Moreover, the sources of risk for equity and low-grade debt are often quite different. For example, the risk of an equity owner includes the risk associated with being last in line (after creditors) in any claim against the corporate assets. On the other hand, even significant risk of senior debt holders, as in the case of a financially troubled company, does not result from the existence of any prior claims.

Finally, proposals such as this one would favor stable and established firms and would be biased against start-up companies, small businesses, venture capital companies, and other inherently risky ventures. Presumably, the rate of deductible interest could be set at a higher rate for such firms, assuming they could be adequately identified, but this would create a bias against still other firms with equal borrowing costs and would raise difficult issues of definition and administration.

Establish a Normative Level of Debt to Equity and Penalize Levels that Exceed this Norm (Option B-7)

The option proposes that, if a corporation's debt to equity ratio exceeds a specified percentage, such as 80 percent, a penalty would be imposed, such as permitting only 50 percent of interest on debt in excess of the ratio to be deducted.

There is no single debt/equity ratio that is appropriate for all corporations. Real estate and financial institutions, for example, have traditionally had high debt/equity ratios; service corporations have not. Even within an industry group, debt/equity ratios vary tremendously depending on conditions in the markets the corporations serve and how capital markets evaluate their managements.

We acknowledge, however, that a high debt/equity ratio is one factor to be taken into account in determining whether a purported debt instrument should be treated as debt for tax purposes. Nonetheless, we think establishing normative debt/equity ratios, and using them in a single-factor test, is highly undesirable.

Replace Corporate Interest Deduction with an Annual Percentage Deduction Based Upon Overall Capitalization (Option B-8)

Under this proposal, the corporate interest deduction would be denied altogether and the resulting revenues would be used to permit, on a revenue-neutral basis, an annual percentage deduction based on a company's overall capitalization. Overall capitalization, however, would be defined for financial corporations in order to permit them to offset interest expense against interest income.

This proposal is apparently based on the view that lenders and shareholders of a corporation are both investors in the corporation and they merely have different claims and rights with respect to the corporation's assets. Under such a view, which is not without its supporters, there is no principled reason for distinguishing the tax treatment of debt and equity. However, many of the issues discussed above in connection with maintaining revenue neutrality within the scope of a particular proposal would apply here as well, including the accuracy of forecasts and the adverse effect on corporate planning. There would also be substantial winners and losers as a result of the conversion to such a dramatically different system, raising significant transition problems.

Limit Deductibility of Accrued but Unpaid Original Issue Discount (OID) (Option B-9)

This proposal would deny the deduction for corporate interest expense on an original issue discount (OID) obligation issued in a transaction in which debt replaces equity until such time as amounts of interest were in fact paid. It is further suggested that this interest disallowance might apply only to OID obligations held by tax-exempt persons and foreign entities.

In general, there is a sound theoretical basis for allowing a current deduction for accrued, but unpaid, OID. In some cases, however, the assumptions underlying the OID rules do not necessarily apply and it may be inappropriate to accrue currently a deduction for unpaid interest. Thus, for example, the proposed OID regulations do not generally provide for current deduction of contingent interest. Where there is a substantial risk of default, it may be more appropriate to treat the discount as contingent and not to permit a deduction prior to payment. These concerns increase as the term of the bond increases. In addition, in certain cases, administrative concerns may argue against current accrual. These concerns are more likely to arise in longer-term zero coupon bonds and bonds providing for payment in the form of new bonds (so-called payment in kind, or PIK, bonds).

Concerns about current deductibility of OID are particularly strong when the instrument is held by a tax-exempt organization or a foreign person, because the issuer has a current deduction for accrued OID (without an equivalent current cash payment) and the holder has no corresponding income inclusion. In the case of OID, current law already reflects this concern on obligations issued to a related foreign person. No deductions are allowed on such obligations until interest is actually paid.

The proposal also suggests limiting the nondeductibility rule to debt that replaces equity. While debt replacing equity tends to erode the corporate tax base, taxing only such debt suggests that all corporations are free to establish whatever capital structure they choose, but that once they have made their choice they have "pledged" not to change the structure if the change decreases their corporate tax liability. That is, a newly organized corporation would be able to treat its interest deductions more favorably than a corporation wishing to recapitalize. Moreover, defining debt that replaces equity is difficult and complicated.

In sum, we agree that certain applications of the OID rules merit further consideration because of the ability of issuers to exploit the rules. Any change in the treatment of the issuer, however, would require careful consideration of how to treat the debtholder.

III. OPTIONS MODIFYING THE CURRENT TAX TREATMENT OF DIVIDENDS

Current Law

Under current law, corporations are generally treated as taxpaying entities separate from their shareholders. A corporation separately reports, and is directly taxable on, the equity holders' share of income. The after-tax income of a corporation is not taxable to its shareholders until it is distributed to them. Dividends paid by corporations other than S corporations are taxed to individual shareholders as ordinary income. Consequently, corporate taxable income paid as dividends to individuals generally bears two taxes, the corporate income tax and the individual income tax. (S corporations are an exception to this rule. Taxable income of S corporations is allocated and taxed directly to its shareholders.)

Corporate shareholders generally are taxed on at most 30 percent of dividends received from other corporations. Intercorporate dividends among members of affiliated groups (each 80 percent or more owned by a common parent) are not taxable to payee corporations.

Discussion

The disparate tax treatment of debt and equity in the corporate sector creates economic distortions. It distorts decisions regarding a corporation's capitalization and its policies with regard to investment and distribution of earnings in ways that detract from the efficiency of the economy. The double taxation of dividends encourages corporations to finance their operations with debt rather than equity.

Prior to the Tax Reform Act of 1986, corporations with shareholders in relatively high tax brackets were encouraged to retain earnings in order to defer the shareholder-level tax and to transform this income into capital gain. With corporate rates now higher than individual rates, and with the tax rate differential for capital gains now eliminated, equity financing of corporate assets has been made less attractive.

The double taxation of dividends also increases the cost of capital for corporations and thereby discourages capital-intensive means of production in the corporate sector. Similarly, it penalizes goods and services that are more readily produced or provided by the corporate sector and the performance of risk-pooling functions that are most effectively accomplished by corporations. Investors are thus discouraged from using the corporate form even in circumstances where nontax considerations make it desirable.

The LBO phenomenon has focused attention on the bias in our tax system against equity capitalization and has renewed interest in proposals that would provide partial relief from multiple taxation of corporate earnings. A partial dividends paid deduction or partial tax credit to shareholders for dividends paid would represent a meaningful first step toward reducing the tax burden on corporate equity. By making equity securities more competitive with debt, either of these options would reduce the existing incentive for corporations to raise capital through issuing debt.

Most of our major trading partners provide some form of relief from the multiple taxation of corporate earnings. Dividend relief in foreign countries typically is provided by means of a shareholder level credit for part or all of the corporate tax, less frequently by means of a reduced corporate rate on distributed profits or a corporate deduction with respect to dividends paid. Some countries provide full relief from the double tax on dividends. For example, Germany, Italy, Australia, and New Zealand allow shareholders full credit for corporate tax paid. Other countries, including Canada, France, and the United Kingdom, provide partial relief from the double taxation of dividends.

Proposals for relief from the burden of multiple taxation of corporate earnings have substantial merit quite apart from the recent considerations related to LBOs. We recognize, however, that revenue considerations limit Congress's ability to provide such relief at this time. The fact that we cannot currently afford to grant such relief, however, should not obscure its desirability as a matter of sound tax policy.

Comments on Specific Options

Provide a Shareholder Credit for Corporate Tax Paid with Respect to a Percentage of Dividends (Option C-1)

The double taxation of corporate earnings distributed as dividends could be partially relieved by allowing shareholders to claim a credit for corporate tax paid with respect to dividends received from the corporation. Under this approach, the corporate tax may be viewed as a withholding tax for a portion of the individual tax on dividends. The shareholder would "gross-up" dividends by the amount of the credit, include the grossed-up amount in income, and then use the credit to offset tax liability. This approach would directly relieve the same amount of the corporate tax for taxpayers at all income levels. We will discuss this approach more fully below in connection with the dividends paid deduction proposal.

Provide Shareholders with an Exclusion from Income for a Percentage of Dividends Paid (Option C-2)

The double taxation of dividends could be partially relieved by allowing shareholders to exclude from gross income a percentage of dividend income. Prior to its repeal under the Tax Reform Act of 1986, a dividend exclusion was provided for up to $100 in dividends for single individuals and $200 for married individuals who filed joint returns.

A dividend exclusion would provide relief from the individual level tax, although the corporate level tax is generally viewed as creating the additional burden from operating in corporate form. A partial dividend exclusion would provide an increasing amount of relief per dollar of dividends to taxpayers in higher tax brackets and therefore is regressive. Although the lowering and compressing of marginal tax rates under the Tax Reform Act of 1986 has ameliorated this effect, we still find this approach less desirable than either a dividends paid deduction or shareholder credit.

Provide a Dividends Paid Deduction (Option C-3)

This proposal would permit corporations to deduct, in whole or in part, dividends paid. Under the option, the deduction could be reduced to the extent the corporation has foreign and tax-exempt shareholders or a compensating tax on such shareholders could be imposed so that one level of tax would be assured.

If the double taxation of corporate earnings distributed as dividends is relieved partially by providing a deduction or credit for only a percentage of dividends paid to shareholders, the tax treatment of dividends and interest payments would not be equalized; however, the present bias against equity would be lessened.

Because both a dividends paid deduction and a shareholder credit would reduce the incentive to retain earnings, corporations would be likely to pay greater dividends and to seek new capital in financial markets. Corporations would thus be subject to greater discipline in deciding whether to retain, and how to invest, their earnings. The increased level of corporate distributions could enhance the efficiency of investments.

The Reagan Administration's 1985 tax reform package included a proposal that would have allowed domestic corporations a deduction for 10 percent of dividends paid to their shareholders. The House tax reform bill included a similar dividends paid deduction proposal phased in over ten years.

Dividend relief proposals encourage distribution of corporate earnings over retention of such earnings. All of these dividend-relief proposals, however, would raise difficult issues, including the treatment of tax preferences, foreign shareholders, tax-exempt shareholders, and new versus old equity. These issues are discussed below.

Treatment of tax preferences. Dividend relief proposals raise issues with respect to whether relief should apply to dividends paid out of tax-free or preferentially-taxed corporate income. If the objective of the proposals is to relieve the double taxation of dividends, it could be argued that providing relief to dividends paid from tax-free or tax-preferred income is not justified. However, if the policy underlying the preference is to provide incentives for certain economic activities, then the preferential treatment should arguably be passed through to the individual taxpayer. Under the latter approach, some shareholders would receive relief for taxes which were not actually paid at the corporate level because dividends were paid out of partially or fully tax-exempt income.

The Reagan Administration's proposal to permit a deduction for dividends paid was limited so that the deduction would have been allowed only with respect to dividends attributable to earnings that had already borne the corporate income tax. Dividends eligible for the deduction would have been paid from a qualified dividend account, which would consist of all earnings that had borne the regular corporate tax, less any deductible dividends paid by the corporation. The dividends paid deduction, therefore, would not have been available with respect to corporate distributions from tax-preference income.

The qualified dividend account would have been increased each year by the amount of the corporation's taxable income (computed without regard to the dividends paid deduction). However, the amount added each year would have been reduced by the amount of taxable income that, because of any allowable preferences or credits, did not actually bear the corporate tax. Even in such a system, however, problems could arise regarding dividends paid out of income from prior years, if the tax rate for that year differed from that of the year of payment.

A shareholder credit system would also require rules regarding the treatment of tax-preferred and tax-exempt income.

Foreign shareholders. Another issue is whether relief should be available to foreign shareholders in U.S. corporations. Unless special rules are devised, a dividends paid deduction would permit corporate earnings to pass untaxed to such shareholders. If the objective of the proposal is to provide relief from double taxation, foreign shareholders should be allowed the same relief as residents. It could also be argued, however, that the proposal is not intended to provide unilateral tax relief on income earned by foreign shareholders in U.S. corporations and that any such relief should be provided by the home country. If it were decided that the United States should not grant relief unilaterally from double taxation, selective relief could be provided through bilateral tax treaties, as other countries with shareholder-credit mechanisms usually do.

The Reagan Administration's proposal for dividend relief would have imposed a compensatory withholding tax on dividends paid to foreign shareholders who are not entitled to the benefits of a bilateral tax treaty. The House version of the 1986 Tax Reform Act would have extended the deduction to a foreign corporation at least half of whose income is from a U.S. business.

Tax-exempt shareholders. The treatment of tax-exempt shareholders creates similarly difficult issues regarding the extent of relief. If relief is provided with respect to tax-exempt shareholders for a portion of dividends paid, either in the form of a deduction to the corporation for dividends paid to tax-exempt stockholders or in the form of a refundable shareholder credit, then the portion of the business income of a taxable entity that is distributed to tax-exempt shareholders would escape taxation entirely. However, if the objective is to tax dividends only at the shareholder level, tax-exempt shareholders should enjoy the same corporate-level relief as other shareholders. If such relief for tax-exempt shareholders is believed to be desirable, it would be provided automatically under the dividends paid deduction approach. Under a shareholder credit approach, such relief could be provided by allowing the gross-up and credit to tax-exempt shareholders (assuming that the credit is refundable).

Such relief for tax-exempt shareholders also could be denied under either approach. For example, the House tax reform proposals contained a provision for a dividends paid deduction that would have denied tax relief to tax-exempt organizations by requiring such organizations to include the deductible portion of dividends paid as unrelated business income. Under a shareholder credit system, tax relief could be denied to tax-exempt shareholders by making the credit nonrefundable.

New versus old equity. Dividend relief would provide a windfall to current shareholders to the extent that such shareholders paid a lower price for corporate stock because of the double tax on dividends. To prevent such windfall gains, dividend relief could be provided only for new equity, but this, too, would create problems. For example, corporations would have an incentive to redeem old shares and to replace them with new shares. Thus, rules would be needed to deny relief for new equity that replaces old equity. Such rules would considerably complicate the tax code.

Both the dividends paid deduction and the shareholder credit can be designed to deal with the special problems discussed above. Although the dividends paid deduction has the advantage of simplicity in that it does not directly affect the computation of the shareholder's tax liability, it does not provide much flexibility. If it is determined that relief should be denied to certain dividend recipients, such as nonresident shareholders in U.S. corporations, the shareholder-credit approach may be preferable because of its flexibility in this regard.

IV. OPTIONS RELATING TO INVESTMENT BANKING FEES

Current Law

Profits and other income, including advisory fees, earned in connection with leveraged buyouts and other mergers and acquisitions are usually taxed as income or gain under generally applicable rules. A special 50 percent excise tax is imposed, however, on any gain from "greenmail payments," defined as payments received in redemption of stock held for less than two years if the redeeming shareholder has made or threatened a tender offer for the stock of the corporation. The excise tax does not apply if the redemption offer was also made to other shareholders. In addition, an employer may not deduct so-called "golden parachute payments," i.e., payments triggered by changes in the ownership of a corporation or its assets, and the employee must pay a 20 percent excise tax on such payments.

Comments on Specific Options

Impose Nondeductible Excise Tax on LBO-Related Income (Option D-1)

This proposal would impose a nondeductible excise tax on income derived in connection with LBOs and other mergers and acquisitions. The tax would generally be at a 5 percent rate, but there would be an additional 20 percent tax on investment banking fees.

This proposal is apparently based on the view that LBOs are unduly stimulated by high fees earned in connection with such transactions. The proposal would apply, however, regardless of whether the fees earned in connection with a particular LBO were inordinately high or whether the LBO was driven by factors completely apart from the fees.

While the fees earned in connection with LBO transactions are clearly substantial, we believe it is inappropriate to tax such fees in a punitive manner. The appropriate level of fees should be set by the marketplace. If the fees being charged to the parties in these transactions are too large, competition should bring them down.

Impose Nondeductible Excise Tax on Excessive M&A Compensation (Option D-2)

This proposal would impose a substantial nondeductible excise tax on "excessive compensation" derived by individuals from services rendered in connection with merger and acquisition activity. The threshold for excessive compensation would apparently be set at a high level (such as $50 million per year).

This is a slight variation on the preceding proposal, and, in our view, it suffers the same defects. By limiting the application of the tax to income above a threshold such as $50 million, however, the proposal seeks to penalize only those who are most successful. It is difficult to identify a sound tax policy that would justify such a rule.

Impose Nondeductible Excise Tax on Certain Advisory Fees (Option D-3)

This option would impose a nondeductible excise tax on income derived from advisory fees that are based on the success of an offer and on the income of financial advisors who both provide an "independent" appraisal of the target company's assets and also play a role in the tender offer for the company.

This proposal is designed to discourage arrangements that raise serious conflict of interest concerns. We share the concerns that underlie this proposal and believe that serious study should be given to addressing them, either under the federal securities law or state corporation laws. Because these concerns are not tax-related, however, it is inappropriate to address them through the tax code.

V. OPTIONS RELATING TO THE TAX TREATMENT OF FOREIGN PERSONS AND TO ISSUES OF FOREIGN INVESTMENT

Current Law

Foreign investment in the United States takes a variety of forms. Two of the most important forms are loans (either to related or unrelated U.S. persons) and direct equity investment through controlled domestic subsidiaries.

Interest paid or accrued to a foreign corporation or nonresident alien is deductible by the U.S. borrower according to the same rules applicable to domestic transactions, except that the U.S. borrower is not entitled to deduct original issue discount on obligations held by certain related foreign persons until the time of actual payment.

Under the general rule, interest actually paid from U.S. sources to foreign persons is subject to a 30-percent withholding tax, imposed on the gross amount of the interest payment. There are, however, several major exceptions to this general rule of taxability. First, the United States does not impose any tax on interest paid to foreign corporations or nonresident aliens (other than banks and persons related to the borrower) with respect to registered debt instruments and certain bearer debt instruments issued in accordance with specified procedures. Similarly, U.S. tax is not imposed on interest paid to foreign persons with respect to deposits with banks and certain other financial institutions, or with respect to original issue discount obligations with maturities not exceeding 183 days at the time of issuance. Finally, the 30-percent withholding tax on interest may be reduced or eliminated altogether under the terms of an applicable tax treaty between the United States and the country of residence of the beneficial owner of the interest.

Like interest, dividends actually paid to foreign corporations and nonresident aliens are generally subject to a 30-percent withholding tax imposed on the gross amount of the dividend payment. There are no statutory provisions that reduce or eliminate this withholding tax, but the tax may be reduced by tax treaty.

Capital gains realized by foreign persons on the sale or exchange of debt instruments are generally not subject to U.S. tax. There are exceptions to this rule for gains on certain debt obligations secured by U.S. real property and gains that are effectively connected with a U.S. trade or business. Gains on the disposition of debt obligations are taxable to foreign persons as interest income to the extent attributable to accrued interest or original issue discount (but not market discount), although the tax on such income may be reduced or eliminated by any of the rules previously discussed.

Similarly, gain realized on the exchange of stock in a domestic corporation, whether in liquidation of the corporation or in a normal sale transaction, is generally not included in the gross income of either a nonresident alien shareholder or a foreign corporate shareholder. There are a number of exceptions to this rule, the most important of which relates to ownership of interests in United States real property.

Discussion

In our view, the dominant issue in the foreign options is the extent to which the obligations of the United States under its many existing tax treaties should be respected. Treasury wishes to reiterate its general objection to the override of tax treaties. Treasury objects to override not merely because it violates our international commitments, but also because it is in most cases inconsistent with the United States' long-term economic and political interests.

Our tax treaties are not unilateral concessions to the interests of foreign persons investing in the United States; they represent a careful balance of interests and confer substantial benefits on many U.S. persons investing overseas. The override of existing tax treaties, and even the recurring threat of override, make it difficult for U.S. treaty negotiators to obtain concessions that will benefit U.S. investors, since foreign negotiators feel that the United States may later renege on its own concessions. Moreover, overrides by the United States will inevitably invite retaliation from our trading partners. For these reasons, it is Treasury's strongly held view that, although Congress clearly is empowered to override U.S. treaty obligations, it should do so only in the most exceptional cases and after full and careful consideration of the consequences of such action. Treasury does not believe that any of the five foreign-related options that are the subject of these hearings presents an appropriate occasion for treaty override.

Comments on Specific Options

Tax on Imputed Income of Domestic Corporations to Account for Offshore Interest Expense (Option E-1)

This proposal would apply to a domestic corporation if it is controlled by foreign persons and otherwise would be subject to a limitation on the deduction of interest expense under one of the interest limitation proposals discussed above. Under the proposal, the corporation would be required to include in its U.S. gross income an amount of additional income to account for "tainted" interest expense borne by related foreign corporations outside the United States. The "tainted" interest expense is interest that would be disallowed if it were borne by a domestic corporation.

It is unclear under this proposal how the correct amount of tainted offshore interest expense would be determined. One approach would be to consider only offshore debt that can be "traced" to the domestic corporation (e.g., acquisition debt). A second approach would be to consider the related group's entire worldwide interest expense and allocate to the domestic corporation its proper share, based on the theory of fungibility of money.

There are a number of serious problems with the proposal. First, the proposal may violate the prohibition contained in numerous of our tax treaties against discrimination on the basis of capital ownership.

Second, the determination of whether taxpayers in a foreign jurisdiction have an unfair advantage over U.S. taxpayers cannot be made on the basis of a single criterion such as the deductibility of interest expense. A host of other factors must be considered, including tax rates, the definition of the tax base, investment incentives, depreciation methods, the treatment of foreign source income, and direct and indirect government subsidies. The problem of focusing on a single criterion is illustrated by the present proposal, which attempts to neutralize the advantage of a foreign acquirer deducting interest paid with respect to debt financing offshore but does nothing about the advantage of a foreign acquirer deducting dividend payments with respect to equity financing offshore (or the advantage for shareholders who receive a credit for taxes paid by the foreign corporation).

Third, the proposal would be difficult to administer and enforce. The proposal assumes, for example, that it is feasible to identify foreign corporations that are related to a domestic corporation. In fact, this can be a very difficult task for the Internal Revenue Service, often requiring the use of harsh statutory or regulatory presumptions. More fundamentally, if administered equitably, the proposal would require domestic corporations to provide the Internal Revenue Service with detailed information concerning the worldwide interest expense of the corporate group and the extent to which such interest expense generates a foreign tax benefit.

Reimpose a Withholding Tax on Portfolio Interest (Option E-2)

This proposal would reimpose a withholding tax on interest paid to foreign persons with respect to certain portfolio debt obligations ("portfolio interest").

Prior to the Tax Reform Act of 1984, a 30 percent withholding tax was imposed on portfolio interest paid to foreign persons, although the tax was sometimes reduced under the provisions of an applicable tax treaty. The tax was eliminated by the 1984 Act, in part because U.S. borrowers were avoiding the tax through the use of foreign finance subsidiaries, and in part because Congress recognized that the tax was blocking efficient access to the rapidly developing Eurobond capital market for U.S. borrowers.

The proposal to reimpose a withholding tax on portfolio interest is objectionable on several grounds. The question of whether to tax portfolio interest was thoroughly debated in 1984, and a decision was made not to tax. Treasury supported that decision in 1984, and we continue to support the decision now. Reimposition of the tax after only five years could significantly disrupt the Eurobond capital market, promote skepticism about the U.S. commitment to particular tax policies in this area, and possibly trigger a withdrawal of substantial amounts of foreign capital from U.S. markets. Moreover, reimposition of the tax would once again erect a barrier against U.S. issuers seeking access to international capital markets. Such a barrier would have no obvious relationship to the debt/equity concerns that are the focus of the current hearings, since access to international markets would be denied to all U.S. issuers, regardless of their degree of leverage or their status as takeover targets. Finally, for reasons previously stated, Treasury opposes any reimposition of a withholding tax at rates that would apply notwithstanding contrary rates prescribed in existing treaties.

Limit Corporation's Deduction for Interest Paid to Related Tax-Exempt Persons Where Interest Exceeds a Certain Percentage of Income (Option E-3)

This proposal would limit a corporation's interest deduction for interest paid to certain related parties to prevent the sheltering from U.S. tax of more than a designated percentage of the corporation's taxable income (computed without regard to the interest deduction or net operating losses). The limitation might be applied only to interest paid to related parties who are not subject to U.S. tax.

The proposal is similar to a provision passed by the Senate in 1986 but deleted from the final Tax Reform Act in conference. Treasury opposed the provision in 1986 and continues to oppose it in its present form. The proposal should be rejected as inconsistent with this country's tax treaty program. The proposal appears to be targeted primarily at related foreign lenders, since they are the related lenders most likely to be exempt from U.S. tax. Interest paid to such lenders is normally subject to the full U.S. withholding tax (because the portfolio interest exemption does not apply to related party interest); thus, the proposal apparently would apply only where the withholding tax has been eliminated pursuant to one of our tax treaties. The proposal, if so targeted, would clearly violate the nondiscrimination article in the relevant treaty.

Allow U.S. Acquirers to Amortize Target's Goodwill or Review Foreign Acquirers' Advantage from Amortizing Goodwill (Option E-4)

This proposal sets forth two alternatives involving the tax treatment of goodwill in acquisitions. Under the first alternative, taxpayers would be allowed to amortize the goodwill in a target corporation over 40 years if the basis of such goodwill were stepped-up as the result of a taxable acquisition of the target (for example, in an acquisition under section 338). Under the second alternative, U.S. treaty policy would be reviewed to determine whether foreign acquirers are given an advantage over U.S. acquirers relating to the tax treatment of goodwill in acquisitions.

Foreign corporations may have an advantage over U.S. corporations in asset acquisitions because the foreign corporations may be permitted a deduction in their home jurisdictions for the amortization of the cost of goodwill. This is the situation, for example, in Japan, West Germany, and Canada, but not in the United Kingdom. We understand, however, that acquisitions of substantial U.S. business assets (as opposed to stock) by foreign corporations are not common in most industries, in part because the operation of a U.S. branch instead of a U.S. subsidiary will often result in less favorable treaty benefits and the earlier and more burdensome imposition of tax on U.S. profits not reinvested in the U.S. business. It is important to note that foreign corporations do not appear to have any tax advantage in stock acquisitions of U.S. targets since, even if the foreign acquirer makes an election under section 338 to treat the acquisition as an asset acquisition for tax purposes, the target's goodwill will remain inside U.S. corporate solution. We are not aware of any foreign jurisdiction that permits its corporations to amortize goodwill for tax purposes under these circumstances.

The treatment of goodwill for financial accounting purposes may also disadvantage U.S. corporations relative to their foreign counterparts. Because some countries do not require that goodwill be amortized for financial accounting purposes (for example, the United Kingdom and West Germany, but not Japan or Canada), corporations in those countries may report higher earnings on their financial statements than their U.S. competitors, which are required to amortize goodwill for financial purposes. As a result, such foreign acquirers may have an artificial advantage in the competition for investors. Treatment of goodwill for financial purposes is not, however, a problem that can be addressed through the tax laws.

Completely apart from concerns over foreign competition, there remains the issue of whether we should permit the amortization of purchased goodwill. An argument can be made that the purchase value of goodwill dissipates over time. In other words, the value of goodwill acquired on the acquisition date steadily declines, and additional costs incurred in sustaining the business go toward the development of new or replacement goodwill. Thus, under present law, taxable income is overstated, relative to economic income, by the amount of the current year decline in value of the intangible asset.

Were goodwill to be viewed as a wasting asset, its acquisition cost should be amortized over its useful life. In light of the difficulty in determining the useful life of such an asset, however, it would be appropriate to fix by statute the period over which the cost should be amortized. For financial accounting purposes, the acquisition cost of an asset in the nature of goodwill or going concern value must be amortized over the useful life of such asset, but not to exceed 40 years (Accounting Principles Bulletin 17). Thus, 40 years would be the amortization period for tax purposes that would most likely conform to the financial accounting treatment of goodwill. It is likely that such a provision would result in a large revenue loss.

Tax Foreign Shareholder's Stock Gains on Liquidation or Sale as Dividend (Option E-5)

This proposal would treat the gain realized by a foreign shareholder on the liquidation of a domestic corporation as a dividend, presumably to the extent of the shareholder's ratable share of earnings and profits. The dividend would be subject to withholding, at either the normal 30-percent rate under section 1441 or 1442 or at a lower rate prescribed by an applicable tax treaty. The proposal also suggests that gain realized by a foreign shareholder on the sale or exchange of the stock of a domestic corporation could be treated as a dividend according to similar rules. Although not mentioned in the proposal, gain recognized by foreign shareholders in stock redemptions could presumably also be treated as a dividend to the extent of the shareholder's ratable share of earnings.

The treatment of gain realized by a shareholder on the liquidation of a corporation as a dividend is a logical subject of study for a number of reasons; many of our major trading partners, for example, currently have such a rule and apply it to domestic as well as foreign shareholders. It is possible, however, that such a rule, by increasing the total cost of equity investments in domestic corporations, could actually increase the incentives to use debt financing.

Moreover, there are a number of complex issues that must be resolved before such a tax rule can be enacted. Many of the complexities relate to the potential for avoidance if the historical shareholder sells prior to the liquidation. In addition, our ability to tax the foreign seller's gain as a dividend may be limited by treaty provisions.

VI. OPTIONS MODIFYING THE TAX CONSEQUENCES RELATING TO CERTAIN CORPORATE FINANCING TRANSACTIONS

These options are of such disparate nature that they can be discussed only as separate proposals.

Impose Excise Tax on Acquisitions (Option F-1)

This proposal would impose a nondeductible excise tax of 3 to 5 percent on the value of certain stock and asset acquisitions. The acquisitions that trigger the tax could be limited to acquisitions of more than 50 percent of the stock or substantially all of the assets of a corporation. The proposal could also be limited to hostile acquisitions. The revenues raised by this proposal would be used "to help small business and venture capital situations."

This proposal is in itself a cluster of options. At its broadest it would be a tax on any transfer of stock or assets. Thus, it seems to be an attempt to raise revenue, and we would oppose it on that basis. In addition, the proposal is not targeted to leveraged acquisitions in that it would seem to apply regardless of whether any debt was used to finance the transaction.

Insofar as the proposal might be limited to hostile acquisitions, we have earlier described our opposition to such proposals. There is no evidence that hostile acquisitions are less likely to be beneficial than friendly acquisitions and the determination of whether an acquisition is "hostile" is fraught with difficulties. These same objections would obviously be applicable here to the extent the proposal is confined to hostile acquisitions.

Reestablishing a Capital Gains Preference for Certain Assets (Option F-2)

This option would provide a 50 percent exclusion for gains from the sale of an asset which is financed through corporate or individual equity (or savings) and held for at least three years.

This proposal resembles the Administration's capital gains proposal in that it seeks to encourage investors to focus on longer term investments by requiring a three-year holding period. However, the proposal is broader than the Administration's capital gains proposal in that it would apparently apply to gains realized on collectibles, and depreciable and depletable property, as well as to gains realized by corporations. The proposal does not provide any special relief for gains of lower income taxpayers, a key feature of the Administration's proposal. On the other hand, the proposal is narrower than the Administration's proposal in that it applies only to property financed through equity or savings. Such a rule would require potentially complex rules to determine whether property is financed by the required sources. While we support long-term capital gains incentives, we believe that this proposal is not as suitably structured as our proposal.

Trigger Gain Recognition when a Corporation Borrows Against Appreciated Assets to Finance Distributions (Option F-3)

Under this proposal, a corporation would recognize gain when it borrows against appreciated assets and distributes the proceeds to its shareholders. The proposal would apply only to the extent the distribution exceeds the amount of the shareholders' contributions to the capital of the corporation plus the accumulated earnings of the corporation. The proposal also includes certain additional rules clarifying its application and implementation.

This complex proposal is apparently intended to shore up the rule of section 311 that treats a corporation as recognizing gain when it distributes appreciated property to shareholders. The concern appears to be that corporations will avoid the effect of section 311 by borrowing against appreciated assets, without recognizing any gain, and simply distribute the proceeds rather than the appreciated assets.

Assuming this is a correct understanding of the proposal, we would oppose it on several grounds. First, our tax system generally defers recognition of gain until a realization event, such as a sale or other disposition occurs. The proposal, in effect, requires a marking to market of the value of corporate assets, with a tax on the corporation based on that value, even though the corporation retains the full risk of loss should the value of the asset subsequently decline. Current law does not generally treat borrowing as a realization event, even in the case of nonrecourse borrowing in excess of the taxpayer's basis in the asset. We would also note that this proposal is distinguishable from former section 453C, which treated certain indebtedness as payment on installment obligations (thus triggering gain recognition), since in the case of an installment sale the realization event (a sale) has already occurred.

Second, the proposal would apparently trigger gain recognition even where there may in fact be no appreciation in assets that could be distributed (and thus trigger section 311 gain). For example, a service business might have most of its value in goodwill, an asset that it could not distribute in a section 311 distribution. The corporation may also own furniture and fixtures with no appreciation and be able to borrow in excess of the basis and value of the furniture and fixtures because of the goodwill value in the corporation and the corporation's earning power. Alternatively a lender might lend more than the value of the assets in the business based on a shareholder guarantee of the loan. Yet if the corporation borrowed in excess of its basis in these assets and distributed the proceeds to shareholders, the proposal would apparently trigger a tax.

Third, when the provision is triggered, gain is to be allocated to all of the corporation's assets including goodwill. This would presumably be done under a method similar to that required under section 1060, which makes the allocation on the basis of the relative fair market values of all the assets. Thus, an appraisal of the corporation's assets would be required. We are disinclined to add yet another difficult valuation and appraisal requirement to the tax code in the absence of more compelling need.

VII. OPTIONS RELATING TO EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

Current Law

An Employee Stock Ownership Plan (ESOP) is an employee benefit plan designed primarily for investment in securities of the employer. ESOPs are generally accorded the same tax advantages as qualified retirement plans. Thus, an employer's contribution to an ESOP is deductible to the employer and not includible in the income of the employee until distributed from the plan to the employee. Income earned on the contribution while held in the plan is not taxable. An ESOP is an individual account plan, which means that each participating employee has an account to which employer contributions in the form of company stock are allocated and the employee is entitled to the value of the account. Thus, the employee, and not the employer, bears the risk of investment gain or loss on stock allocated to his account.

The tax law provides numerous additional advantages to ESOPs and transactions involving ESOPs. First, there is an exception to the prohibited transaction rules generally applicable to qualified plans, permitting an employer to secure loan financing through a leveraged ESOP. In a leveraged ESOP, either the ESOP borrows money from a lender, and the employer guarantees the loan, or, alternatively, the employer borrows from a lender and then makes a mirror loan to the ESOP. In either case, the proceeds of the loan are used to acquire employer securities, either directly from the company or on the open market. The stock acquired serves as collateral for the loan, and is held in a suspense account to be allocated among employees' accounts as the loan is repaid. The employer then makes annual tax-deductible contributions to the ESOP, which are used to pay down the loan. As the loan is repaid, the shares of stock are released from the suspense account and allocated among employees' accounts pursuant to the plan's allocation formula.

Second, section 133 of the Code provides that in the case of an ESOP loan, a bank or other qualified lender may exclude from its income 50 percent of the interest received with respect to the loan.

Third, section 404(k) of the Code provides that an employer may deduct cash dividends paid with respect to employer securities held by an ESOP if the dividends are either (i) paid to the participants (directly or passed through the ESOP), or (ii) applied to make payments on an ESOP loan. Where dividends are used to pay down a loan, the dividend deduction applies to dividends paid with respect to both allocated and unallocated securities. Where dividends paid with respect to allocated securities are used to repay an ESOP loan, a participant who would have otherwise been entitled to the dividends paid with respect to his stock must receive an allocation of additional securities equal in amount to the dividend.

Fourth, under section 1042 of the Code, if an individual sells stock to an ESOP and reinvests the proceeds of the sale in securities of another corporation, the individual does not recognize any gain on the sale. Rather, the individual recognizes the gain, if any, upon subsequent disposition of the replacement securities. In addition, under section 2057 of the Code, if an estate sells stock to an ESOP, the estate may, under certain circumstances, deduct from the value of the gross estate as much as one-half of the proceeds of the sale.

Other ESOP preferences facilitate loan financing and include exceptions from generally applicable qualified plan rules. The applicable deduction limit for employer contributions to a qualified plan is increased from 15 percent to 25 percent of participants compensation to the extent the contributions are to repay principal on an ESOP loan. Also, substantially greater allocations of benefits to highly compensated employees are permitted under ESOPs than under other qualified plans (up to $60,000 instead of $30,000), and the additional income tax on early withdrawals from qualified plans does not apply to distributions from ESOPs.

Under current law the various tax advantages are available to an ESOP without regard to whether the company maintains any other qualified retirement plan for the employees covered under the ESOP.

Discussion

ESOPs are used both in LBO transactions and to defend against potential takeovers. In an LBO transaction an ESOP may be used to take a company private and create a company that is entirely employee owned, or alternatively, an ESOP may be one of several players in an LBO, as for example where a management group takes a company private and establishes an ESOP as one source of financing. In either case, the various tax benefits for ESOPs may play a significant role in reducing the costs of the transaction.

ESOPs are also frequently established as a defensive tactic to protect against unwanted takeovers or LBOs. This is accomplished by establishing an ESOP that acquires a significant portion of voting stock, thus placing a significant number of voting shares in the hands of employees, who it is presumed (perhaps incorrectly) will vote against a hostile tender offer, thus making it more difficult for a raider to acquire a sufficient number of shares to consummate the transaction.

Comments on Specific Options

Repeal Interest Exclusion on ESOP Loans and Deduction for Dividends on ESOP Stock (Options G-1 and G-2)

These options would repeal or reduce the exclusion for interest received with respect to ESOP loans and repeal the deduction for dividends paid with respect to ESOP securities (except to the extent that corporate dividends are otherwise deductible).

While we are committed to encouraging meaningful employee stock ownership through the ESOP mechanism, the Treasury Department believes that the Committee should consider whether some of the newer tax preferences afforded to ESOPs, including the interest exclusion for ESOP loans, the deduction for dividends paid with respect to ESOP securities, and the nonrecognition of gain on sales of stock to ESOPs, are appropriate. The Treasury Department believes that these new tax benefits afforded to ESOPs may not be justified either by the role of ESOPs as retirement plans or their aggregate effect on corporate performance, and that further study of the appropriateness of these additional tax benefits should be undertaken.

We are concerned that the substantial tax preferences available to ESOPs could lead to abuse. These tax preferences could make them an attractive method of corporate financing, thereby increasing the tax system's bias in favor of debt financing. The interest exclusion results in a significantly lower interest rate on corporate borrowing. Similarly, the deduction for dividends paid with respect to ESOP securities and the ability to use the dividends to repay the debt make establishing a debt-financed ESOP a more attractive means of raising new capital. Under our current estimates, the revenue loss attributable to the interest exclusion alone will be approximately $3 billion over the five-year budget period. Recent increases in ESOP activity suggest that this revenue loss estimate may, in fact, be conservative. While we would oppose any reduction in legitimate incentives for meaningful employee stock ownership, we urge the Committee to be vigilant against the potential for abuse.

Permit ESOPs Only As Supplemental Retirement Plans (Option G-3)

Under this proposal, a company would be permitted to maintain an ESOP that is 100-percent leveraged only where the employer also maintains another, meaningful, qualified retirement plan or, alternatively, the extent of leveraging permissible under an ESOP would be limited.

We do not believe that it would be appropriate to require that an employer maintain some other qualified retirement plan as a precondition to maintaining a leveraged ESOP. We are particularly reluctant, in light of recent congressional concerns about section 89, to embark on the difficult and complex task of defining a "meaningful" retirement plan.

VIII. MISCELLANEOUS

The central concept of this group of proposals is to restrict tax benefits (such as interest deductions) if a merger or acquisition fails to comply with one or more rules that could be adopted. The rules that are contemplated tend to address fairness, conflict of interest and disclosure issues.

Discussion

While we understand the concerns that underlie these proposals, they do not arise as a result of our tax laws, and we believe the tax laws are not an appropriate means for dealing with them at this time. As a general matter, these concerns are more properly addressed under federal securities and state corporation laws.

IX. CONCLUSION

We at the Treasury intend to continue to monitor LBOs. The conclusions we express today reflect our view that the economic evidence currently available does not justify major steps such as limiting interest deductions. We are particularly concerned that such actions, once taken, may themselves become an impediment to future corporate tax reform to reduce the bias against corporate equity investment.

Fundamental change in the corporate tax system should come only after careful study--and after workable and stable methods of financing such change have been devised. We intend to continue a constuctive dialogue with the Congress to develop proposals which will result in long-run improvements to the corporate tax system.

Mr. Chairman, that concludes my formal statement. I will be happy to answer questions which you and Members of the Committee may wish to ask.

Mr. **Dorgan**. Chairman Rostenkowski.

Chairman **Rostenkowski**. Thank you, Mr. Chairman.

Mr. Secretary, the conclusion in your statement—I have to tell you that I am pretty disappointed with your prepared statement and the conclusions that you have drawn.

For months now, we have been waiting for the administration to take a position on this issue, and in fact I was at least of the opinion that Secretary Brady had taken one.

When Secretary Brady appeared here before this Committee on January 31 of this year, he stated, and I quote:

> If you were going to make a change, and the Treasury is not suggesting one, but if you were going to make one, we would suggest that you look in the area of perhaps limiting interest deductions but use that money, the moneys so generated to give a break to corporate owners of stock who are doubly taxed, thereby trying to bring the values of those two securities more into balance.

I asked the Secretary directly if he was suggesting shareholder credit for equity relief, and his answer was that it could be a good idea. As recently as a few weeks ago on a Sunday talk show, I believe he once again expressed interest in the area of limiting interest deductions to provide equity relief.

Here today, I believe you are back to square 1. Your role, as far as I am concerned, is to provide tax policy advice to this committee. And yet, after months of examining this issue, the best you can do is tell us that you are monitoring, and you are concerned, but you want further study before anything is done.

In fact, Mr. Assistant Secretary, I think you are retreating. You are concerned about the differing treatments of debt and equity, but you are no longer interested in the very idea advanced by Secretary Brady himself just a few weeks ago to address this problem.

What happened? Why has Secretary Brady changed this position? Can you help me with that?

Mr. **Wilkins**. Yes, Mr. Chairman. I do not believe this is a change of his position.

Let me also quote one thing the Secretary said when he was before you at that time. He said,

> At this particular point in time,

and this was in response to a question by Mr. Frenzel,

> At this particular point in time it seems to me, that we are at a crossroads with regard to LBO's. We have a habit in this country of correcting things we think are wrong just as they are about ready to correct themselves. In my opinion, what we ought to do is watch a little longer.

I believe the Secretary's point is that a solution is not required right now. We want to monitor what is happening in LBO activity. If things get worse, then a solution may be required.

One is not required now. The Secretary certainly expressed that it was a good idea and something he wanted to think about. He had not given it full study to see what the technical problems were, but moreover, he had not put it forth as a proposal that he thought we ought to go ahead with at this time.

Chairman **Rostenkowski**. Well, we are continuing, by evidence of these hearings, to watch what is happening at the market place with the entrepreneurs, and you might suggest to Secretary Brady that maybe there is not the generated activity because of the fact that we are interested in the possibility of legislation.

Now it does not say that we have come to any conclusion, either, but I would expect of this Chairman of this Committee a little bit more of a direction from the Treasury.

Thank you very much, Mr. Chairman.

Mr. **Dorgan**. Mr. Pickle.

Mr. **Pickle**. Thank you, Mr. Chairman.

Mr. Secretary, I was concerned by your conclusion and statement, also, in which you said that you are not prepared to make any recommendations at this time. And now you just said we ought to wait and see if things get worse, then we might take action.

How are they going to get much worse than the RJR fiasco that totaled over $25 billion? That is about the maximum, we would think at this point in time, that has happened. I think all of corporate America and the people are concerned that this type of takeover can occur.

What could get worse? Do you judge it by the amounts? It seems to me like this RJR deal is about the end of the road as far as acceptability is concerned, and something needs to be done.

Now, my question to you is if you think we ought to monitor it and we ought to study it, when will you make that recommendation? Three years ago the Oversight Subcommittee of the Ways and Means Committee looked into the question of junk bonds, and the administration then decided that the situation was not too favorable, but we ought to study it some more and not take action. So we did not for 3 years. We had not done anything.

Now you want the same thing. When you say that you are studying it, do you have a proposal you are going to send up to the committee for us to consider?

Mr. **Wilkins**. We do not have a proposal at this time because we do not think, at this time, that we need to address this specific issue.

We are very cautious about some of these rather overreaching proposals that would deal not just with the LBO issue but that would deal generally, say, with putting limitations——

Mr. **Pickle**. Mr. Secretary, some of them might be overreaching. We receive 15 different proposals or more—some of them may be overreaching.

But the question is what can we do—nothing?

Mr. **Wilkins**. The question is what ought to be done at this time and it is our view that, at this time, we ought to do nothing to directly affect the LBO issue because we see it leveling off. I believe, I do not have it in front of me so I am paraphrasing—that Chairman Greenspan over the weekend said he also thought LBO activity seemed to be leveling off. We are not still in that steep incline.

Now the RJR-Nabisco deal, I think, was an attention getter—no question about that. It was $25 billion, and it got everybody's attention. But I am not prepared now to say whether, in the long run, it was a good deal or a bad deal. It is very difficult to pass judgment on these things ahead of time.

That is one reason why it is very difficult to draw tax rules. They must say, "This is a good LBO; that is a bad one." I do not know which are good or bad, and I do not see how any of us can judge that ahead of time——

Mr. PICKLE. But it is difficult——

Mr. WILKINS. But the size of the deal does not determine that answer.

Mr. PICKLE. I agree with you. The size is not the only factor to consider.

But I think it is an indication to the American people that financiers have learned now that through takeovers they can make more money than they could if they bought a company and produced a product. And that is just what is happening.

Now I am waiting for some kind of recommendation, and if we cannot get one from you, I think this Congress is going to try to find some way to put a cap on these things.

About all I get from you, sir, and from the others who have testified so far that the only thing they would do was remove the double taxation on dividends but make no changes on interest deductions and capital gains.

Now, is that your answer? Is that what you think?

Mr. WILKINS. Well, I think that——

Mr. PICKLE. As I understand it, that is what some in the Administration have said?

Mr. WILKINS. I think that is the fundamental problem. I think LBOs are a symptom of that more fundamental problem. We have a fundamental bias in this country which is not shared by most other countries.

Mr. PICKLE. As one member, I am just saying that I think we have got to be careful—I agree with you on that. We ought not try to hurt business in their mergers and acquisitions because some of them are good.

But I do think we have reached a point where it is obvious something needs to be done. Now I do not think the answer, as you say, is to study it some more.

If you could give us a suggestion, I think this Committee would like to have it. If you cannot, and if the Secretary says, "I have retreated and I am not going forward—I have changed my position," I will think, then, it is left up to us to decide what can we do.

Mr. WILKINS. If I may just respond to that, I do not believe the Secretary has retreated or changed his position. I believe what the Secretary intended all along was that, if the situation warrants it, he would be ready to come in with a proposal. So far, it does not seem to warrant it, in our opinion.

Mr. PICKLE. Well, the Secretary did say at this first hearing that he did not know his position to recommend any big change except that if he did make any change, a limitation on interest would probably be the best place to look.

He did not say that. You do not deny that, do you?

Mr. WILKINS. Pardon me?

Mr. PICKLE. I said you do not deny that the Secretary did state publicly that if we were to make a change, probably the best place to look would be a limitation on interest deductions.

Mr. WILKINS. Well, I believe that what he was saying was that if you were going to limit interest, which I believe is the context in which this came up, then could spend that money on a dividend deduction. This certainly is something that would make some sense to think about.

I do not think he was proposing, at that time, any limitation of interest. I grant you that he did couple it—and he went along with some committee discussion—but I do not think he has changed his position. We simply do not feel that that is needed now, and therefore, it is not appropriate and we are not recommending it.

Mr. DORGAN. Mr. Wilkins, just so that we can understand from a tax policy standpoint what your current thinking is, you say in your testimony that because the rate in increase of mergers and acquisitions, including hostile takeovers, has abated, that gives you some good feelings and represents good news.

Many of us take a different position. We would say that mergers and acquisitions have exploded—virtually exploded—from $13 to $15 billion in the mid-seventies to over $225 billion now, and you are saying because, although they are now at $225 billion a year, the rate of increase is slower, that is good news.

Is there an area of activity that would concern you? At what level do you get concerned about this speculative activity in mergers and acquisitions? Is there a level at which you get concerned, and if so what is it?

Mr. WILKINS. Well, my point, first, was that although there has been an increase—a steep increase—it seems to be leveling off now. We are reaching a period of stability it would appear from the data we have so far.

Mr. DORGAN. But my point is stability at the top, and if you think where we are now is alarming, reaching stability at an alarming level does not give us much comfort. That is the precise reason I asked you the question.

Is there a level at which you become concerned?

Mr. WILKINS. I am not sure that I would be concerned by merger and acquisition activity by itself. I think we have to look into the data a good deal. For example, LBO activities—I know you are aware—do not always result in a larger conglomeration of business. They often end up in disconglomeration.

Of all of the acquisitions that have taken place as LBO activities, many are becoming separate businesses once more. So, although these are in the data that you and I are both looking at, in the long run I am not sure that we are ending up with more concentration than we had before. We may have ended up with less concentration. That may be good; that may be bad. It is not clear to me that greater or lesser concentration, in and of itself, is good for the economy, good for workers, good for America.

Mr. DORGAN. Mr. Wilkins, when the Secretary was here, he said that he was going to solicit advice from the business community and Wall Street on what, if anything, should be done.

Has that advice been solicited, and if it has, what has been that advice from the business community?

Mr. WILKINS. I think that solicitation that was made public when he was here—I think that was his solicitation——

Mr. DORGAN. All right. And what did it result in?

Mr. WILKINS. We have received very little, if any specific advice. The main advice that we have received is go slow, be very careful before you make a drastic move. That is the general advice. We have not received specific proposals.

Mr. DORGAN. I found it curious when the Secretary said he was going to—in fact, he said it more precisely—I had written it down at the time—that he thought if there was a problem in this area that we would hear about that from Wall Street and would get some potential solutions from them. It had occurred to me at the time that he had not heard about the fox in the chicken coops.

I do not expect you are ever going to get much advice from Wall Street on what to do about a problem they do not perceive as a problem.

Mr. WILKINS. Well, I think that was an open invitation beyond Wall Street to the business community generally, and I suspect we would have heard if there were some good answers for us.

Mr. DORGAN. On page 14 of your testimony, you deal with the original issue discount bonds. The testimony is the only hint of a suggestion that maybe you are willing to go beyond study or discussion.

The hint is that—let me read it, if I might—"In sum, we agree that certain application of the OID rules merit further consideration," which is really the only breath of oxygen I get out of much of this testimony.

If that is the case, if they merit further consideration and would suggest changes in treatment of the issue, have you given some thought to that? Do you have any suggestions or plans or do you have any offerings that you would give us today?

Mr. WILKINS. I do not think I am prepared with a specific proposal other than the ideas that we have put forth in this testimony.

The general principle of OID still makes sense to us, but the fact that you do not always have a balance—if some OID's are never paid, you do not always have the proper balance on the side of the recipient—is an issue of some concern, and this is an area in which we would like to work with the committee to develop something.

Mr. DORGAN. Let me ask you for just a moment about junk bonds. I understand that the question of whether an issue is debt or equity is the line that is drawn down in Treasury or the Internal Revenue Service? Is that right—in that the determination of what represents debt versus equity is something that you determine coming from existing law.

Some suggest that some of the junk bonds that are issued these days really represent venture capital masquerading as debt, and that the folks downtown have pretty much been looking south instead of north on these issues. Maybe being a little more aggressive would get us to a position of having fewer of these issues—at least for those of us who consider the issues risky and in the long-term, potentially dangerous, as the issues increase, give us some comfort.

What is your general feeling about junk bonds and the question of equity versus debt?

Mr. WILKINS. First, my general feeling about junk bonds is I cannot prejudge them and say, because they all have high rates, they are bad. It is true we do make judgments on debt versus equity. That is part of the role IRS takes in administering the laws. We tried, as you are aware, with section 385 to come up with bright lines. We had a lot of difficulty and those regulations have been withdrawn.

Nevertheless, on a day-by-day basis on a case-by-case basis, that is something that is carried out at Treasury. Debt/equity ratios are only part of it.

I am well aware that many people's view is that junk bonds are very much equity-like because they have a good deal of risk associated with them. I do not think we can say that all high interest bonds, which would fall under the junk bond definition, however, are of that sort. That is not our view.

Mr. DORGAN. Mr. Wilkins, let me interrupt you there.

Is there anything underway, that you know of, in Treasury or the Service to look at some of these issues that walk closer to the line? I mean do you have any enforcement movement any place down there that would take a look at some of these because there are a lot of gimmicks and games going on with respect to the issuance of junk bonds these days?

Mr. WILKINS. I think the general answer is that this is something that is going on all the time, day by day. We have not simply dropped out of the picture because section 385 regulations are not out there. This is something IRS does on a day by day, case by case basis. There are rulings all the time on this.

Mr. DORGAN. Well, let me also echo the chairman's concern.

It seems to me that to the extent that the Secretary has said anything to this committee, and he, frankly, has not said much because he basically said,

> Well, I am not too concerned about what is going on here, but someday Wall Street will let us know if there are problems and give us some potential solutions.

But beyond that, the one glimpse of a positive note that we have heard was that maybe if we were to do anything—at least in the Secretary's mind, the least onerous, or the better approach might be an interest deduction. Your testimony today seems to walk away from that.

Is your testimony today that under all conditions we should do nothing at this moment?

Mr. WILKINS. Well, I cannot separate all conditions. My testimony today is that conditions do not warrant us doing anything at this time, specifically on LBO's and, more importantly, limiting interest deduction, which would likely go far beyond the LBO issue.

This is not a change in what the Secretary had in mind when he was here before the committee before. I am aware of what he said. He said it is a good idea. He also did not say it is an idea we need to propose and go forward with today. It is an idea that we need to study, and it is an idea that, if conditions change, if LBO's continue and get out of hand, if you will, then we would certainly come up with a serious proposal. He did not say this is a proposal that he endorsed at that time, that we ought to call an official administration proposal.

Mr. DORGAN. And just so that we can understand a little better the framework in which you present to us your analysis, can you tell me, again, are there conditions you think should prompt us to take some action, or do you see this development of a national or international casino as something that is generally healthy and done in the name in capitalism? Are there no conditions under which you would come to Congress and say, "Let's do something here?" Are there conditions under which you might recommend some changes? If so, what might they be in the future so that we have some notion of what your thinking is down there?

Mr. **Wilkins**. Well, I have difficulty speculating on how economic conditions might change. I think it is always true that if economic conditions change drastically, policies change in response to them.

I do not want to get into hypotheticals, though, and at the moment the conditions are such that we do not feel we do need——

Mr. **Dorgan**. But it would be helpful for you to get into some hypotheticals just so we understand.

You might very well, and the Secretary might very well feel that the sky is the limit here. We are people that do not want to interfere, ever. If that is the case, we probably should know that because some of us might feel very strongly. That is just a kind of a bankrupt position.

Mr. **Wilkins**. I think, Mr. Chairman, if there is clear-cut evidence that LBO's are doing serious economic harm to the country, that would be a time when we would step forward.

We do not, at the moment, see that occurring. It is not clear that takeovers are hurting the economy. It is not clear that hostile takeovers are necessarily hurting the economy. That has to be played out.

Mr. **Dorgan**. Is it conceivable to you that the incredibly risky position that some are in. Given the proliferation of junk bonds and other expansion of debt this could put us in the same position, probably not quite as great, but in a similar position as the S&L crisis because you will discover the risk and the adverse consequences of that risk when there is an economic down turn. Then you come to us and say, "Well, it has happened?"

Is that conceivable that you will come back later and say, "Well, now we are in the middle of this suit, now we got to do something about it?"

Mr. **Wilkins**. I do not think it is conceivable. I do not think the kind of people that are investing in LBO's are the same kind of people—investors—that we are concerned about in the S&L crisis. We are not worried about the average saver, the average American.

They are very sophisticated investors. They know what they are doing. Granted, there are risks involved, and they know if there is an economic downturn, there may be some problems. I do not see that these problems are any worse than we would have if the LBO phenomenon were not happening. There are always going to be highly leveraged firms. They are going to be the ones that may find the most difficulty.

I do not think we will be coming back to you. This is not like the S&L crisis.

Mr. **Dorgan**. Again, just one final question, and I need to call on my colleagues, but I do not think all LBO's are bad. I happen to think some probably make a lot of good sense and should move forward.

Admitting that, let me ask you. Do you think some are terrible and dangerous, and if so, how do I identify them, and should there be public policies developed to deal with those?

Mr. WILKINS. I think it is extremely difficult to set forth a set of criteria to identify those that are bad and dangerous and horrible as you say.

The only way people generally do so is after the fact, to see what harm may have been done. But you have to be extremely careful, even then, as to what criteria to use.

There can be some transitional unemployment through divestitures that take place through an LBO—that, if you have a slightly longer time horizon, is good for the economy. I am not saying we want to encourage something that is going to create some temporary unemployment. We worry about it.

But I am trying to point out that it is very difficult to come up with a set of criteria that you can say, "This LBO was a bad one; that LBO was a good one." The best we can do is well after the fact and even then we are going to make some mistakes.

Most importantly, I do not see any way we can do this in the Tax Code or that it is appropriate to try to do it in Tax Code.

Mr. DORGAN. You know what my problem is? I sense there is this orgy of speculation in this country, much of which is dangerous, and we are sort of expecting you to ride fence, and you do not even have a horse. I mean you are not even out there. That is my concern.

And I sense that you come to us—Treasury comes to us and says, "There is no problem here. Everything is just fine." And I worry that 5 years from now or 2 years from now in an economic down turn, we are up to our neck in defaults, and we are trying to figure out how do we deal with the enormous consequences of that.

Now maybe it is just a disagreement on economic policy and tax policy, and I hope that the Treasury and the committee can cooperate to try to identify where should we be concerned? Where are the limits? Where are the levels in which we might take some action?

Let me turn it over to my colleagues.

Mr. WILKINS. As we say, we would have every intention of cooperating, and I think—the thrust of my testimony, where we want to deal with this, probably, is on a more fundamental level, not just looking at LBO's but looking at the basic problem, the bias against equity financing that we have.

Mr. DORGAN. But, Mr. Wilkins, the thrust of your testimony has been, and it has been constantly—we do not think you should do anything. And what I was trying to understand is maybe that is an intellectual judgment after looking at all of the facts, or maybe that is just a philosophy, and if your philosophy down there is do nothing ever, then maybe we need to understand that that philosophy does not work here. We need to be in charge, in control and deal with some of these problems.

Mr. WILKINS. I understand what you are saying, and I guess what I should have made clear is that I am speaking, really, from a tax policy point of view. We are talking about whether there are tax policy answers to these questions.

I am not saying that it is not a problem of any sort, that we ought not monitor it. We are monitoring it.

Mr. **Dorgan**. Because you think it might be a problem?

Mr. **Wilkins**. What?

Mr. **Dorgan**. You are monitoring it because you think it might be a problem?

Mr. **Wilkins**. Yes, it could be a problem. I think we are as concerned as the committee. If it starts to go up a lot, I think we will worry about it. But I do not think we will worry about it from a tax policy perspective. We do not see it as something that can be addressed or should be addressed through the Tax Code. So let me make that concern more narrow.

Mr. **Dorgan**. Well, some of us are worrying for you.

Mr. Anthony.

Mr. **Anthony**. Thank you, Mr. Chairman.

Mr. Wilkins, when Secretary Brady appeared before the committee earlier I asked him about his position on ESOP's. And as you state in your testimony on page 33, you are committed to encouraging meaningful employee stock ownership through the ESOP mechanism.

He stated that the administration liked ESOP's and employee ownership. In fact, I quote him. He said, "I think it is a terrific idea."

He said, though, that he did have a concern over a situation where the ESOP may be a weigh station or temporary in a context of a takeover fight.

I want to make sure that you and I understand each other's position. You, in your testimony, representing the administration, are continuing to support the transfer of capital ownership, equity ownership to employees through the ESOP mechanism. Is that the way I take your testimony to read?

Mr. **Wilkins**. That is right. We think that a legitimate ESOP establishment, whereby the employees become the owners, is probably a very good idea. The President supports that, the Secretary supports it, we at Treasury do.

Mr. **Anthony**. And you are not coming before this committee today recommending as an official administrative position that this committee seek to repeal any specific provision of the current Tax Code as it relates to ESOP?

Mr. **Wilkins**. We are not recommending repeal of any specific provision.

What we are recommending is that we need to take a closer look to make sure there is no abuse of the ESOP provisions. We do not have any specific recommendations, and the last thing in the world we want to do is to see ESOP's harmed.

Mr. **Anthony**. I will agree with you today as I agreed with Secretary Brady when he testified, that I also want to see them prosper, and I do not want us, from a tax policy, to restrict them, but at the same time I would not be supportive of what would be considered to be abusive uses of them.

So I would like to be able to work with you, especially in your further study if you have specific positive corrections that you think may be needed as you continue to study the overall situation.

Just recently, and I guess maybe as a result of your testimony and as a result of these hearings, I did receive a call from a panicked constituent. The business is the Mad Butcher. It is a 100 percent wholly owned business—a chain of grocery stores in the State of Arkansas.

The President called me and left a message at my home that my wife took down—very cryptic—and when I came in last night, I could not quite make any sense out of it until I picked up the options that the committee had prepared for us, and on page 7(g), options related to employee stock ownership plans, number 3. I had my staff person go and call him on the phone to get specifically what he was concerned about.

It turns out that that if this option is enacted, would it totally place him out of business. If there is a clean ESOP arrangement this particular one certainly would pass every criteria. However, it is his interpretation that if option G–3 were adopted by this committee, he would be forced to terminate his ESOP.

Now note on page 33 that you have a position that you have testified to. Is it my understanding that you are in opposition to option G–3, and that you think we would be making a mistake by trying to get into that area?

Mr. WILKINS. That is correct.

Mr. ANTHONY. Especially in light of section 89?

Mr. WILKINS. That heightens my focus. That is right.

Mr. ANTHONY. Our concern over section 89 has been so heightened that the chairman has introduced a bill that has been cosponsored by every single Democrat, and I think probably close now to a majority of the Republicans on this committee.

So I thank you for those clarifications, and I yield back the balance of my time.

Mr. DORGAN. The gentleman from Pennsylvania, Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Wilkins, you have referred to the policies of other nations in your testimony, particularly the EC and how we might be guided by some of their tax policies. I was wondering if you were aware that the EC has proposed legislative rules that would require a company initiating a takeover to state its plans concerning the future of the target company especially its plans for the work force.

I wonder if you think we might review these initiatives as possible options here in the United States?

Mr. WILKINS. Let me say that I am not—to make my position clear—I am not saying we ought to look to Europe and the EC for our policy options. I, in no way, necessarily think their tax systems are better than ours. Indeed, I suspect ours makes a lot more sense for us.

The only purpose of bringing that in my testimony is to point out in the competition area, they do give deductions of one sort or another to equity capital and we do not. So in that narrow focus, we need to be cognizant of what is happening among our trading partners, in the EC and elsewhere.

I did not mean to infer that we ought to be patterning our tax system after theirs because there are many things in their systems we are not going to want. I am not aware of the proposal you mentioned, but I am not sure at all it is something we would want to adopt.

Mr. COYNE. You do not think that would be useful information?

Mr. **Wilkins**. Well, I have not seen the proposal fleshed out. I would certainly read it and reflect on it, and I would be happy to get back to you. But it does not sound to me like something that would be consistent with the position we have taken today.

Mr. **Coyne**. Thank you.

Mr. **Dorgan**. Thank you very much.

Mr. Wilkins, one final question. Has the Department or anyone else, to your knowledge, done any analysis of what the potential consequences might be of a severe economic down turn with respect to the pyramid of junk bonds and highly leveraged companies that have been involved in LBO's? Anybody understand what the consequences might be of a severe down turn?

Mr. **Wilkins**. I think a severe downturn would not be heightened by the junk bond phenomenon. I think that what we are going to find is that certain firms are going to be severely hurt by a downturn. Certain firms are always at the bottom of that pyramid and get more hurt than others. It may be different firms now—it may be that firms that have just gone through an LBO transaction will be hurt most.

There is evidence, however, that these large debt situations get paid off fairly rapidly. So a firm that has gone through an LBO may not be hurt if this downturn—as you hypothesize—comes a couple of years after—3 or 4 years after the initial transaction took place.

But I think the LBO phenomenon is changing the part of the players. I do not think that the economy as a whole is in any worse of a situation because of the LBO phenomenon or the junk bond phenomenon. There will clearly be people hurt. There will be people who are not hurt, and we may be changing the players, but I do not think there is any increased overall risk.

In fact, some people would say that because of the LBO phenomenon, people are more apt to work out a solution—a more highly leveraged company may, in fact, be more apt to try to work out with creditors an agreeable position before it goes belly-up.

Mr. **Dorgan**. Well, I respect your opinion. My question was slightly more specific.

Has there been any specific studies or comprehensive analysis of the potential consequences of an economic down turn given the highly leveraged nature of some of the enterprises as a result of LBO's and given the amount of junk bonds that now exist?

Mr. **Wilkins**. I am not aware that anything with that specific focus has been done.

Mr. **Dorgan**. Would that be important or useful or should we go with——

Mr. **Wilkins**. I think a study of what will happen to the economy in a downturn is always something an administration is concerned about. All I am saying is that I am not aware there has been any special focus on LBO's, junk bonds per se. But interest rates have always been a part of that kind of analysis.

It is only with your focus, I am saying, that I am not aware that anything has been done; but there is always concern about what happens when the economy changes. That is something Treasury worries about, the Council of Economic Advisers worry about——

Mr. **Dorgan**. The Treasury Secretary, when he was here, indicated that in his judgment, the disparate treatment between the equity and debt is what has generally persuaded the increase of LBO's.

Many of us feel that is inaccurate, and in fact the junk bonds, the ability to find a market and liquidity for junk bonds represents the engine that has driven much of these LBO's.

Give me your opinion.

Mr. **Wilkins**. I think I would basically side with the Secretary on that, that the LBO and the junk bonds are——

Mr. **Dorgan**. I wonder why I am not surprised by that. [Laughter.]

Mr. **Wilkins**. Are more a symptom than they are a root cause.

Mr. **Dorgan**. And your position would be that in the absence of a market for and liquidity for high yield instruments, or so-called junk bonds that we would probably have the same stimulus for and the same level of LBO activity in the country today?

Mr. **Wilkins**. There may be some effect. But I just do not know what the answer to that would be.

Mr. **Dorgan**. Mr. Andrews, did you have any further inquiry?

Mr. **Anthony**. No questions.

Mr. **Dorgan**. All right.

Mr. Wilkins, thank you very much for your testimony. We appreciate you being here.

Next the committee will call on Mr. Arnold Cantor, assistant director, the department of economic research, the American Federation of Labor and Congress of Industrial Organizations.

Mr. Cantor, would you come forward and take your place, please?

[Pause.]

Mr. **Dorgan**. Mr. Cantor, the committee will accept your complete testimony as a part of the permanent record. We would ask that you summarize for the committee, and we appreciate very much your willingness to be here and testify.

STATEMENT OF ARNOLD CANTOR, ASSISTANT DIRECTOR, ECONOMIC RESEARCH DEPARTMENT, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, ACCOMPANIED BY MEREDITH MILLER, SOCIAL SECURITY DEPARTMENT; AND WILLIAM CUNNINGHAM, LEGISLATION DEPARTMENT

Mr. **Cantor**. I will, Mr. Chairman, and thank you.

Mr. **Dorgan**. Would the members of the audience please take seats and give Mr. Cantor a chance to be heard.

You may proceed.

Mr. **Cantor**. Mr. Chairman, I am accompanied by Ms. Meredith Miller of our social security department on my right, and Mr. Bill Cunningham of our legislative department on my left.

The AFL–CIO is pleased to have this opportunity to present its views on alternative tax changes to deal with the serious problems stemming from the current wave of corporate mergers, acquisitions, and leveraged buyouts.

We would also like to commend the committee for its study of the issues and urge that you now take decisive legislative action.

We also hope our appearance today helps to focus some attention on the impact of buyouts on workers and ordinary people. We all have witnessed innumerable discussions of winners and losers in terms of financial markets, corporate managers, investment bankers, stockholders, bond holders, arbitrageurs, lawyers, brokers, and the like.

Much too little attention has been paid to the fact that worker's investments in their jobs are by their very nature long-term, and rarely do the interests of workers, their families, or their communities coincide with the horizons of the players who are benefiting from the leveraging of America.

Last February, AFL–CIO president, Lane Kirkland, presented this committee with a long but far from exhaustive list of examples chronicling union job losses—totaling over 90,000 people—that were the result of takeovers, defending against takeovers and leveraged buyouts.

We have attached that list, again, and we have also attached a copy of the Wall Street Journal article of May 10, which cites a new study of LBO's refuting the KKR study with findings that show a loss of jobs and a decline in the research, development, and investment expenditures of the post-buyout entity.

Kirkland noted the common ingredient in these and other restructurings is a quantum increase in debt, which then gives rise to extraordinarily high servicing costs, pressures to cut wages and benefits, and close downs or sales of assets and operations.

Mr. Kirkland called for a disallowance of the deduction for interest on debt to finance an LBO, a takeover, or retirement of equity. And that remains our position today.

The fact that corporate income that is paid to debt holders in the form of interest is tax exempt, whereas corporate income that is paid out in the form of dividends is not deductible, and is taxed at both the corporate and individual levels, is a powerful tax incentive for debt financing.

Moreover, as a result of these sharp cuts in individual and corporate marginal rates, particularly the former since 1981, the relative advantage of debt over equity has increased dramatically. Under certain conditions, the tax advantage of debt over equity under current law could be nearly five times as great as it was prior to 1981.

The results of the enlarged tax advantage and the obvious growth in the market for debt instruments show up in a huge shift toward that financing. From 1981 to 1987, according to the Federal Reserve Board, the nonfinancial corporate business sector retired $295 billion in equities while adding $813.2 billion to net corporate indebtedness.

This switching of corporate capital structures from equity to debt also has undercut the corporate tax base. From 1980 to 1985, according to Treasury data, corporate interest expense as a percent of taxable income before interest deductions rose from 36 to 47 percent, meaning that corporate tax revenues were $50 billion lower than they would otherwise be in that year.

As a tax policy matter we see no real reason to tax a dollar of debt financed income any lower than a dollar financed by an equity investment. And, the distinction between debt and equity has always been a muddy and elusive one. Neither the Congress nor the Treasury have been able to define a clear boundary line. However, as a practical matter, we do not feel that now is the time for fundamental overhaul of the tax structure.

We do feel, however, that there is an urgent need to remove the tax subsidy element from the merger-acquisition-LBO equation through placing constraints on the interest deduction.

In addition, we believe action should be taken with respect to the original discount obligations in transactions involving debt being replaced by equity.

We support necessary measures, including the reenactment of the 30-percent withholding tax on portfolio income—to preclude advantaging foreign investors over U.S. investors in situations where denial of interest deductions would not affect foreign investors whose tax burden is determined outside the jurisdiction of the tax laws.

We are also opposed to "greenmail" payments and "golden parachutes," and we urge you to adopt much more punitive measures than currently exist.

Lastly, as a tax matter, we do not believe the committee should be troubled by the possibility that action in any of these areas would lead to increased Federal tax revenues. We would consider tax measures such as we have suggested to be well within the spirit of loophole closing tax reform and well suited for use in deficit reduction.

My prepared statement also has a number of the recommendations that we have made to other committees who have been studying this issue, and they will be, as you say, in the complete record.

In closing, we feel that Congress should encourage entrepreneurs and managers to measure their success not through their ability to game the tax system but through their skill in increasing production, and developing new products and technologies, and providing well-paid productive jobs.

We urge you to make the necessary changes to assure that the tax code no longer paves the way for leveraged transactions that are counter to the economic interests of our Nation.

We do, of course, look forward to working with you to assure a speedy resolution of these issues.

Thank you very much.

[The statement of Arnold Cantor follows:]

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TESTIMONY OF ARNOLD CANTOR, ASSISTANT DIRECTOR, ECONOMIC RESEARCH DEPARTMENT AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS BEFORE THE COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES ON MERGERS AND ACQUISITIONS

May 16, 1989

The AFL-CIO is pleased to have this opportunity to present its views on alternative tax changes to deal with the serious problems stemming from the current wave of corporate mergers, acquisitions and leveraged buyouts.

We would also like to commend the committee for its study of the issues related to LBOs which you began earlier this year and urge that you now take decisive legislative action.

We hope our appearance today helps to focus some attention on the impact of buyouts on workers and ordinary people. We all have witnessed innumerable discussions of winners and losers in terms of financial markets, corporate managers, investment bankers, stockholders, bondholders, arbitrageurs, lawyers, brokers and the like.

Workers' investments in their jobs are by their very nature longterm and rarely do the interests of workers, their families or their communities coincide with the horizons of the "players" who are benefiting from the leveraging of America.

Workers are being victimized directly through job and income losses as the economic health and vitality of employers is skimmed off. And these same people will suffer first and longest as a debt-laden economy becomes more and more vulnerable in the event of an economic downturn and private and public investments essential to progress are postponed or foregone.

Last February, AFL-CIO President Kirkland presented this committee with a long but far from exhaustive list of examples chronicling union job losses--totalling over 90,000--that were the result of takeovers, defending against takeovers and leveraged buyouts (attached). We have also attached a copy of a Wall Street Journal article (May 10, 1989) which cites a new study of LBOs that refutes the Kohlberg Kravis Roberts & Co. (KKR) claims, with findings that show a loss of jobs and a decline in the research, development and investment expenditures of the post-buyout entity.

President Kirkland noted the "common ingredient in these and other restructurings is a quantum increase in debt which then gives rise to extraordinarily high servicing costs, pressures to cut wages and benefits and close downs or sales of assets and operations."

At that time, Mr. Kirkland stated that "...the amendment to the (tax) code most closely fitted to the immediate problem would be to disallow the deduction for interest on debt to finance a LBO, a takeover or the retirement of equity."

Events since that time have served to reinforce our belief in the gravity of the situation, and, therefore, the need for legislative measures adequate to the task. In that context we are particularly pleased to note that options which "modify" the current tax treatment of corporate interest deductions enjoy a prominent position among the options that are the subject of today's hearing.

The fact that corporate income that is paid to debtholders in the form of interest is corporate tax exempt, whereas corporate income that is paid out in the form of dividends is not deductible, and is taxed at both the corporate and individual levels, is a powerful tax incentive for debt financing. Moreover, as a result of the sharp cuts in individual and corporate marginal tax rates--particularly the former--since 1981 the relative advantage of debt over equity has increased dramatically.

Under certain conditions the tax advantage of debt over equity under current law could be nearly five times as great as it was prior to 1981.

For example, in 1980, the top corporate rate was 46 percent and high bracketed individuals were taxed at a 70 percent marginal tax rate. Under those circumstances, $100 of corporate income distributed to stockholder was taxed first at the 46 percent corporate tax rate and the balance--$54--paid out to the stockholder was taxed at 70 percent or $37.80 for a combined rate of 83.8 percent. If the same $100 was paid to a bondholder, the total tax burden would have been $70 or 70 percent. The differential in that case was 13.8 percentage points (83.8 percent compared to 70 percent) which works out to an effective tax rate on dividends paid 19.7 percent higher than on interest.

Under current law, however, with the highest income individuals paying a top marginal rate of 28 percent and a 34 percent corporate income tax rate, similar calculations result in an effective tax rate on dividends of 52.5 percent compared to a 28 percent tax rate on interest -- that difference of 24.5 percentage points works out to an 87.5 percent rate differential between the tax on dividends paid and interest.

The results of the enlarged tax advantage and the obvious growth in the market for debt instruments show up in a huge shift toward debt financing. From 1981 to 1987, according to the Federal Reserve Board the non-financial corporate business sector retired $295 billion in equities while adding $813.2 billion to net corporate indebtedness.

The switching of corporate capital structures from equity to debt also has undercut the corporate tax base. From 1980 to 1985, according to Treasury data, corporate interest expense as a percent of taxable income before interest deduction rose from 36 to 47 percent. If the share of corporate income excluded from taxes as a result of interest payments had stayed at its 1980 level, the corporate tax base in 1985 would have been nearly $50 billion higher.

As a tax policy matter, we see no real reason to tax a dollar of debt financed income any lower than a dollar financed by an equity investment. And, the distinction between debt and equity has always been a muddy and elusive one. Neither the Congress nor the Treasury have been able to define a clear boundary line. However, as a practical matter, we do not feel that now is the time for a fundamental overhaul of the corporate tax structure.

We do, however, feel that there is an urgent need to remove the tax subsidy element from the merger-acquisition- LBO equation through placing constraints on the interest deduction.

In addition to our above mentioned recommendation to disallow the deduction for interest on debt used to finance an LBO or equity retirement:

* We believe action should be taken with respect to the original discount (OID) obligations in transactions involving debt being replaced by equity. The committee should consider changes in the OID rules in situations that involve LBOs so that these rules no longer help subsidize debt for equity swaps.

* We support necessary measures--including the reenactment of the 30 percent withholding tax on portfolio income--to preclude advantaging foreign investors over U.S. investors in situations where denial of interest deductions would not effect foreign investors whose tax burden is determined outside the jurisdiction of U.S. tax laws.

* The AFL-CIO is opposed to "Greenmail" payments and "Golden Parachutes." Even though current law taxes greenmail at a 50 percent rate and golden parachutes at 20 percent, these practices are continuing. We urge you to adopt more punitive measures.

* We do not believe the committee should be troubled by the possibility that action in any of these areas would lead to increased federal tax revenues. We would consider tax measures such as we have suggested, to be well within the spirit of loophole closing tax reform and well suited for use in deficit reduction.

* We support passage of the Employee Pension Protection Act (H.R. 1661 and S.685). This past April, AFL-CIO Secretary Treasurer Thomas Donahue in testimony before this committee's oversight subcommittee detailed the

Federation's concerns with the role of pension assets in leveraged buyouts and related transactions. In that statement, Donahue noted our support for the Employee Pension Protection Act which contains basic pension protection for workers and retirees in the event of a reversion and supported the recent Treasury and Labor Department clarifications on fiduciary responsibilities.

We have also called for changes in the nation's securities laws to improve the tender offer process by requiring that raiders provide communities with detailed disclosure about their plans from the new company, lengthening the time given to stockholders to respond to tender offers and by prohibiting two-tiered offers. In addition, Congress should review issues concerning shareholders rights.

We urge the committee to reject the self-serving arguments of those who claim LBOs present no problems and therefore no tax changes are needed. Claims that junk bonds are being paid off, and that LBOs contribute to the economy miss the point that profitable productive facilities have been closed, research and development eliminated, wages slashed and jobs have been destroyed in order to service overwhelming debt burdens.

Congress should encourage entrepreneurs and managers to measure their success not through their ability to game the tax system but through their skill in increasing production, developing new products and technologies and providing well-paid productive jobs.

We urge you to make the necessary changes to assure that the tax code no longer paves the way for leveraged transactions that are counter to the economic interests of our nation.

We do, of course, look forward to working with you to assure a speedy resolution of these issues.

Thank you.

Number of Jobs Lost as a Result of Takeover Attempts, Takeovers, and Leveraged Buyouts

Unions Involved	Circumstances	Estimated Number of Jobs Lost
United Food and Commercial Workers	Safeway Stores was subject to a takeover attempt by the Dart Group Corp., owned by the Haft family of the Maryland suburbs of Washington, D.C. Safeway avoided the takeover in two ways. First, it settled with the Hafts by acquiring their shares at a price which left them with $100 million in profit and also paid them an additional $59 million to buy back from them rights to purchase stores in the Washington, D.C., area, which had been given to them originally. Then Safeway management went through a leveraged buyout under the auspices of Kohlberg, Kravis, and Roberts, buying back enough shares from the public to gain control of the Safeway corporation. The Safeway corporation then ended up with a debt of about $4.1 billion. Safeway has since embarked upon a program of closedowns and/or sales of stores in a few regions of the country. This included all 141 stores in the Dallas-southwestern states region, as well as a regional headquarters and distribution center. In smaller communities on the Eastern Shore of Maryland and Delaware, 8 stores were closed down. Other areas were also affected, and the number of job losses continued to grow. In January, 1988, the Kansas City Division, involving 3,400 employees, was sold in a local management LBO; workers who had been through one round of concessions in their previous contract negotiations had to go through another round. In March 1988, Safeway Stores in the Arkansas Division, including stores in Arkansas, Louisiana, and northern Texas, were sold in a local LBO; and 2,500 union employees were forced into substantial wage and benefit cuts in order to preserve their jobs.	9,500 jobs lost
	Lucky Stores, a western states food supermarket and general merchandise store chain, fought off a raid by Edelman and ended up in a much weaker financial situation. The Lucky Stores management retained control of their corporation but decided to liquidate all of their Gemco general merchandise stores in California and Arizona and concentrate on its food store business. The Gemco stores closedown caused the net unemployment of 6,000 out of 14,000 persons that had been employed in the stores; the rest had employment rights for vacancies in other stores owned by Lucky Stores under a union contract. Both the Safeway Stores and the Lucky Stores contractions are a reaction to a larger debt burden which causes stores (or plants) that had previously been marginal producers of net earnings to become submarginal, because higher earnings are required to service the debt. In such circumstances, stores or operating units may be shut down or sold to people who have	6,000 jobs lost

Unions Involved	Circumstances	Estimated Number of Jobs Lost
	stores in the same locality or region or plants producing the same products. The latter may close down some acquisitions or reduce the size of the operation.	
	In February 1988, in order to stave off a hostile bid by the Hafts (trading as Dart Group Corp.), Stop & Shop stores enlisted the services of KKR to structure a leveraged buyout which was done successfully at a price per share of stock which added $1.4 billion in outstanding debt to S&S, which then sold 58 of its Bradlees department stores to help pay down the debt. Bradlees stores, employing 3,000, were closed down; and the stores leased to Hechinger Company, a hardware and housewares chain with stores in Maryland, Pennsylvania, and Virginia, who presumably would use the stores as added outlets in its chain; but Hechinger then decided the stores would compete with those already in its chain and sold the leases. There were 3,000 former Bradlees employees out of work.	3,000 jobs lost
	In January 1988, Grand Union, operator of 360 food supermarkets, was spun off by General Electric of France through a leveraged management buyout. In March 1988, Grand Union sold its 52 Colonial/Big Star stores in Virginia and North and South Carolina to Harris-Teeter corporation, an adamant anti-union employer. Two thousand union members lost their jobs and their union contracts.	2,000 jobs lost
Glass, Pottery, Plastics and Allied Workers	Diamond Bathurst, which was a company with three plants, acquired three other firms (Thatcher Glass, Glass Container Corporation, and Chattanooga Glass Company). It then, in 1984, had a total of 22 plants with 7,883 employees. It closed eight of the plants and now has only 4,075 employees.	3,800 jobs lost
	Owens-Corning Fiberglas fought off a takeover attempt by the Wickes Companies, during which it bought back stock that cost about $3.5 billion. It ended up with a debt of $2.6 billion and a large cutback in operations, and the number employed was reduced by between 12 and 13 thousand.	13,000 jobs lost
	In April 1988, there was an attempted takeover of the American Standard plumbing fixture manufacturing company by Black & Decker, a manufacturer of hand tools and household electronics. American Standard embraced Kelso and Co. as a "white knight" to keep out Black & Decker, who was willing to retreat for related legal reasons. The State of Delaware, in which American Standard was incorporated, had enacted a law that would greatly delay, if not wholly block, a hostile takeover attempt. It required the hostile	350 jobs lost

Unions Involved	Circumstances	Estimated Number of Jobs Lost
	suitor to obtain 85 percent of outstanding shares before he could assume control. Black & Decker sued in federal court to have the law declared unconstitutional on grounds that it violated the "interstate commerce" clause. The court ruled against Black & Decker, which then sold its share holdings to Kelso and withdrew. Kelso acquired enough shares in the market to gain control. Before the Kelso "rescue," in negotiations with the union, the American Standard management had cited company assets totalling $3 billion and debt of $400 million. After the Kelso-management stock purchase, the debt had mounted to a staggering $2.8 billion, and the company had to borrow about $2.7 billion. In October 1988, the company announced that it would close down the Wauregen, Connecticut, plant, where 341 employees were employed and would lay off about 16 salaried employees at a Tiffin, Ohio, establishment.	
Retail, Wholesale and Department Store Union	Gimbels Department Stores. In the 1970s, the Batus corporation, a British holding company, obtained majority control of the Gimbels Department Store operation, including its subsidiary, Saks Fifth Avenue. Batus held the property and allowed it to be operated as department stores until the real estate on which the Gimbels stores were located became valuable. Then it closed the Gimbels stores in late 1986, early 1987, to rebuild for other uses. (The most profitable Saks Fifth Avenue stores have remained in operation.)	5,000 jobs lost
	Jacob Suchard of Switzerland acquired Brock Candy and closed down one of the three plants.	160 jobs lost
United Rubbber, Cork, Linoleum and Plastic Workers of America	In 1986, Goodyear Tire & Rubber Company fought off a takeover attempt by James Goldsmith. Goldsmith walked away with $92 million in greenmail. To buy back his stock, and shares held by the public, Goodyear added $2.6 billion to its debt. It greatly reduced and then closed down operations at its Kelly Springfield Tire Company plant in Cumberland, Maryland, which had employed 800; and through forced early retirements and layoffs, also had a 600-person reduction of its headquarters staff; and then in 1988, induced another 438 in Akron, Ohio, and at tire plants elsewhere, to retire early.	1,800 jobs lost
United Paperworkers International Union	After Crown-Zellerbach's James River paper company was acquired by James Goldsmith in a hostile takeover, 1,000 employees were laid off in October 1985.	1,000 jobs

Unions Involved	Circumstances	Estimated Number of Jobs Lost
United Steelworkers of America	When Lykes shipping company took over the Youngstown Sheet and Tube Company in 1969, the head of Lykes announced that he would use the cash flow of Youngstown Sheet and Tube, about $100 million a year, as he saw fit. He proceed to do so, and one of the two Youngstown plants, the Campbell Works in Youngstown, an older plant, was allowed to run down. Instead of having equipment replaced, the Lykes company milked Youngstown Sheet and Tube. Youngstown Sheet and Tube also had another newer plant which was in good shape, and Youngstown Sheet and Tube assets were later sold to Jones and Laughlin, which then was merged with LTV. The latter closed the Campbell Works, which had employed 4,000. One subsidiary of an acquired firm, Enduro Products, had to be sold off for anti-trust reasons; and it went bankrupt, and 700 jobs were lost. In 1984, LTV also acquired Republic Steel, and it then closed more of its plants.	Total of 13,800. Estimated 13,100* of total of 109,000 work force reduction between 1971 and 198 due to closedown of merger acquisition plants. Also, 700 jobs lost at Enduro Products after sell-of
Amalgamated Clothing and Textile Workers Union	Pacific Holding Corp. through a leveraged buyout acquired Cannon Mills Co. in January 1982 for $413 million. After the acquisition, many mills were closed or sold. In January 1986, most of the remaining plants were sold to Fieldcrest, which closed or sold 4 mills. Employment decreased from 23,200 in January 1980 to 15,500 in December 1985.	9,200 jobs lost
	Tultex, Corp. acquired Washington Mills in July 1982 for $17 million; closed Marion, North Carolina, plant in November 1984.	500 jobs lost
	Dan River -- leveraged buyout by investor group for $154 million in May 1983; subsequently, plants employing 4,086 closed or sold -- employment reduced from 12,000 to 8,000.	4,000 jobs lost
	Cone Mills Corp. -- leveraged buyout for $420 million by members of existing management March 1984 -- when employment was 10,944; sold Union Bleachery plant in Greenville, South Carolina -- employment in November 1985, 10,000.	940 jobs lost
	TI-Caro, Inc. -- leveraged buyout for $190 million by members of existing management May 1984; plants sold off in Burlington and Graham, North Carolina, and closed a plant in Cleveland, Tennessee -- employment reduced from 5,700 to 4,700 by November 1985.	1,000 jobs lost

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*Between 1971 and 1986, LTV closed a number of plants and dismissed 78 percent of the work force of the three acquired companies. Six other major steel companies reduced their combined work force by only 66 percent over the same period. If the additional 12 percent of the LTV reduction was attributed to the effect of excessive merger acquisitions, it would account for 13,100 of the dismissed workers.

Unions Involved	Circumstances	Estimated Number of Jobs Lost
	Gold Mills/Saratoga/FFF by Guilford Mills --fired 350 employees at Saratoga when both Saratoga plants closed (1986).	350 jobs lost
	Cluett, Peabody & Co., Inc. merged into West Point-Pepperell January 1986 — 10 U.S. plants sold or merged.	3,300 jobs lost
	Blue Bell, Inc. leveraged buyout (1984) for $470 million, then acquired on July 27, 1986 by VF Corporation. Employment reduced from about 20,000 to 18,800.	1,200 jobs lost
	Health-Tex -- leveraged buyout for $230 million in 1985; closed three plants (1986-87).	1,300 jobs lost
	Levi Strauss & Co. — leveraged buyouts for $1.7 billion by investor group — sold many plants to meet payments incurred by the buyout.	5,200 jobs lost
International Chemical Workers Union	Granite City Steel bought out by National Intergroup and Nippon Steel in 1984.	250 jobs lost
	MK Laboratories of Fairfield, Connecticut, go bankrupt after LBO in 1988.	140 jobs lost
	American Salt LBO by General Host in 1988.	60 jobs lost
	Hilton-Davis LBO of Sterling Drug in Cincinnati.	300 job reductio
	Cities Services plant in Copperhill, Tennessee, 650 loss after Tennessee Chemical LBO in 1982.	650 jobs lost
	Dow bought Morton plant in Kanakee, Illinois in 1984 -- closed production; closed distribution center in 1988.	170 jobs lost
	Four original Harshaw plants in Ohio and Kentucky bought by Engelhard from Kaiser in 1988.	Cutbacks -- net loss of 390 jobs
United Auto Workers	General Motors sold TEREX Division to IBH Holding AG of Germany through an LBO in December 1980 after a struggle and bankruptcy; and TEREX acquired through second LBO by Northwest Engineering in 1987, and ceased operations shortly thereafter. Total job loss -- 2,800 workers.	2,800 jobs lost

TOTAL ESTIMATED NUMBER OF JOBS LOST: 91,160

HBS:ehb

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Two Scholars Blast KKR Buy-Out Study That Reached Pro-Takeover Conclusions

By THOMAS E. RICKS
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON—A study by a visiting Brookings Institution economist and another academic blasts a ballyhooed study of leveraged buy-outs by LBO giant Kohlberg Kravis Roberts & Co., criticizing its methodology and challenging its pro-takeover conclusions.

The new study, by William Long, a former Federal Trade Commission economist who is now a guest scholar at Brookings, a Washington think tank, and by David Ravenscraft, an economist at the University of North Carolina's business school, says that Kohlberg Kravis's positive conclusions about LBOs are at best "premature," and perhaps the result of faulty research.

The Kohlberg Kravis paper, which was distributed in January to several interested congressional committees and was the subject of a Wall Street Journal story, argued that LBOs boost employment; increase research-and-development spending; yield higher taxes for the government; keep capital spending strong, and result in companies that can withstand recessions.

The Long-Ravenscraft study observes that other studies of LBOs reached very different conclusions, finding that LBOs reduce employment and decrease R&D and capital spending. Had Kohlberg Kravis used better methodology, the two scholars say, its findings might have been reversed.

"The one KKR result that is verified by other post-LBO research is that LBOs yield high returns to investors," the study concludes.

The Long-Ravenscraft study, which will be presented later this month at a New York University conference on takeovers and corporate governance, hasn't been formally released. But it is circulating in draft form and already provoking comment in Washington. The study was discussed yesterday at an off-the-record session at Brookings attended by Federal Reserve aides, congressional staffers and other government officials.

Rep. Edward Markey (D., Mass.), chairman of the House finance subcommittee, which has been studying LBOs for several months, said in a statement: "I look forward to hearing KKR's detailed response to this study."

An outside spokesman for Kohlberg Kravis, whose LBOs include Beatrice Cos., Safeway Stores Inc. and the record $25 billion purchase of RJR Nabisco Inc., said: "We can't comment about something we haven't seen, and we think doesn't exist in any fixed form yet, that isn't finished, and is in need of substantial correction."

Mr. Long said he has been in contact with a representative of Kohlberg Kravis about the paper. He also disputed the assertion that the paper needs to be corrected. "In our view, the current draft doesn't contain errors," he said.

In a leveraged buy-out, a small group of investors buys a company in a deal financed mainly by borrowing. Ultimately, the debt is paid off with funds generated by the target company's operations or the sale of some of its assets.

Messrs. Long and Ravenscraft, who are seeking funding for their own proposed major study, are generally critical of the studies of the effects of LBOs, finding "weaknesses" in all of them. But they single out the Kohlberg Kravis study as especially biased in several areas.

They note, for example, that a Kohlberg Kravis representative confirmed to them that the firm's study in one area uses business projections rather than historical data. The Kohlberg Kravis study appears to be reporting data on what happened to 17 companies during the three years after they were acquired by Kohlberg Kravis, they say. But, they continue, seven of those companies were bought by Kohlberg Kravis in 1986 or later, making such data unavailable.

They say this confusion of actual and expected performance is especially serious because Kohlberg Kravis's later LBOs are so much larger than earlier ones that the projections skew the study's numbers on employment, capital expenditures and R&D.

Mr. Long said this is why the Kohlberg Kravis study found a slight increase in the capital expenditures of companies taken over in LBOs, while two other studies found decreases.

Similarly, the economists are critical of Kohlberg Kravis's differing treatment of acquisitions and divestitures following an LBO. The effect of that is to inflate the employment figures in the study, Mr. Long said. "We can only say for sure that there's an upward bias," he said. "We don't know how big it is."

Mr. **Dorgan**. Mr. Cantor, thank you very much. Do we have other statements?

Thank you very much.

Mr. Schulze, do you wish to inquire?

Mr. **Schulze**. Thank you, Mr. Chairman. I would like to thank the gentleman for his presentation.

Just one question. Are there instances where mergers and acquisitions in small and medium-sized businesses gives them expanded capacity and capabilities? Can you see instances where it is beneficial to have a series of mergers or acquisitions?

Mr. **Cantor**. Certainly. I would just like to emphasize that our statement and our presentation is concerned basically—for want of another term—with predatory practices. Practices that are, in fact, harmful.

Mr. **Schulze**. Where I have a problem is how do we determine whether it is beneficial or whether it is harmful? Every time we say that the Federal Government is going to play God I get a little bit nervous.

Mr. **Cantor**. I think at the risk of sounding a little brusque, my familiarity with corporate tax law is that it is just chock full of all kinds of considerations and standards and differences and exceptions.

But I think, again, our issue here is the tax subsidy element. I think too features have to be taken into consideration. We feel that if you are doing anything, and you should do something, it should be in the context of the interest deduction. And we think the other kind of broad criteria would be in situations where there is a swap of debt for equity, a dollar for dollar.

So we do not want to preclude legitimate productive investment by no means.

Mr. **Schulze**. Is there a happy middle ground, in your opinion? Should we say a percentage of that interest would not be deductible or do you think that should deny the entire deduction?

Mr. **Cantor**. I am certain there are, Congressman. Again, I think we are arguing more toward, again, the two directions, the interest deduction and the tax subsidy element. We are not enforcing the law, obviously.

Mr. **Schulze**. Thank you.

Thank you, Mr. Chairman.

Mr. **Dorgan**. Mr. Coyne.

Mr. **Coyne**. I have no questions.

Mr. **Dorgan**. Mr. Anthony.

Mr. **Anthony**. No questions.

Mr. **Dorgan**. Mr. Cantor, let me just pose a couple of brief questions.

You, undoubtedly, were here and heard part of the testimony by the Assistant Secretary for Tax Policy, Mr. Wilkins——

Mr. **Cantor**. Yes, I did.

Mr. **Dorgan**. His position was, essentially, that there really is no problem here at the moment, and we should just continue to study. If there develops a problem we will hear about it from the business community and they will offer us some solutions. That was, at least, the Secretary's position, and he seemed to echo a part of that. Nothing really is happening to be greatly concerned about, and no public policy changes, particularly in the area of tax policy, are desirable or necessary at this point.

You take a substantially different view. How does the committee evaluate whether Mr. Wilkins and his boss, the Secretary are dead right on this or whether your concerns are better-founded. How do we make judgments in that area?

Mr. **CANTOR**. Well, as I think you put it earlier in your questioning, I think the Assistant Secretary was, in the sense, being intellectual and philosophical in espousing a philosophy that, as you know, we do not share and I suspect you do not either.

But I think the issue speaks for itself in the appendix that we have attached to our testimony, and these are anecdotal examples. These are people—just to paraphrase an old cliche—who cannot wait for the long run, and are hurt by this every single day of the year, and communities and tax bases and families.

Mr. **DORGAN**. Mr. Cantor, you do not believe that all LBOs are improper or detrimental? I assume there are some that are beneficial and appropriate and should occur?

Mr. **CANTOR**. Yes, sir, I certainly do.

I do not think, though, that the tax structure should be subsidizing the issue.

Mr. **DORGAN**. Do you think, Mr. Cantor, that if junk bonds were largely eliminated—I should rephrase that—we will never eliminate nor should we eliminate high yield bonds. If we change the conditions under which they were issued so that there were substantially fewer of them, would that diminish the drive for these LBO's? Is that the engine of activity here—the junk bond?

Mr. **CANTOR**. I do not know. In that sense, I think I share some of the Assistant Secretary's remarks. I think they are a symptom——

Mr. **DORGAN**. Then I withdraw my question. [Laughter.]

Mr. **CANTOR**. And truthfully I think they are a symptom of the fact that there is a group of people with the amount of money. Maybe it comes down to a fundamental income distribution problem where there are enough people around with enough loose and speculative bucks to be buying these things. I think that is a very, very deep problem, and maybe the fundamental problem.

Mr. **DORGAN**. Mr. Cantor, the testimony you have given today and the testimony previously offered by Mr. Kirkland is very helpful and an interesting and useful perspective, and the committee thanks you very much.

Are there other questions? Mr. Shaw.

Mr. **SHAW**. Yes, I just have one, and I was not here for the previous questions, so perhaps the questions have already been answered.

But how do you distinguish between a leveraged buyout that should not be, as you say, subsidized by the Federal Government through the deduction of interest, and one that should be? That is a problem I think this committee is facing.

Mr. **CANTOR**. But that is why we really selected among the options the proposal that we did in that we feel the key factor should be the swap. We are not talking about a net additional increase in debt. We are talking about a situation where, on a dollar-for-dollar basis, the only thing you are spending money on is your own stock. You are not spending money on new facilities, productive investment, or what have you. You are buying up your own stock, or you are floating debt as a substitute for equity.

Mr. SHAW. All right. Let me follow that up, if I could, then.

What if you have the employees buying out an existing business?

Mr. CANTOR. Again, in that kind of situation, No. 1—I suspect you are talking about the ESOP situation—we really have not taken any overall position on that. But our basic feeling on the ESOP issue is that it is not so much the tax—the problems are not so much in the tax area, and the problems are more in the risk put on the workers in their substitution very frequently for a pension plan that is a defined benefit pension plan, and the actual fact of whether or not there is worker participation.

The specific proposal that we are making, as I see it, should not affect an ESOP because it is a fund that is tax exempt.

Mr. SHAW. I think you realize the problem and the dilemma that this committe is facing.

I quite agree with you. I do not think we ought to be subsidizing these high-risk junk bonds for people that are simply going in and raiding corporations, selling off their parts, or just coming in and streamlining the corporation in one way or the other without developing any new capital, which this country desperately needs.

Mr. CANTOR. Again, Congressman, that is why we have not focussed on proposals that would, for example, put a higher interest rate on certain bonds and then consider that, in fact, equity, because I think there are situations where you will have small corporations or high-tech corporations that need start-up capital, that are riskier operations, and might have to float bonds that bear high interest rates.

I believe sincerely that the type of proposal we are recommending does not require that kind of line drawing.

Mr. SHAW. Well, I think we are all struggling with the same thing how you legislate in this area without doing violence to a system that has served us well over the past years.

Thank you, Mr. Chairman.

Mr. ANTHONY. Mr. Chairman.

Mr. DORGAN. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman. I would like to go on the record as firmly supporting one of the proposals that you have in your testimony.

On page 4 you talked about "greenmail" and "golden parachutes." Although we have attempted to restrict the ability of certain corporate officials, raiders to be placed in a very favorable situation as opposed to the workers, in general.

I do not think we have gone far enough, and I think this is an area where we can take an additional look. And I think if we can squeeze out some of the protection in terms of greenmail and other protection in terms of golden parachutes, I personally believe that that might have some downward depressant upon the overall area of some of these takeovers.

I know it has got to be especially grating on your employees that eventually get laid off because the plant has been shut down only to pick up the paper and read where somebody has been rewarded, and basically what they were awarded for is because they have to be in a position of power to negotiate out a very nice employment contract.

I must tell you I am totally in sympathy with that, and I think we have got to continue to try to level the playing field in those regards.

So if you have any specific proposals that you would like to have Bill submit to us, we would like to take a close look at those in the event of a markup or something does move forward in this particular Congress.

Mr. DORGAN. Would the gentleman yield?

Mr. ANTHONY. I would be happy to yield.

Mr. DORGAN. On the point about greenmail, the committee accepted my amendment in the 1987 Reconciliation Act which composed a 50-percent excise tax on greenmail. The effect of that was to impose a 50-percent excise tax on top of the 28-percent income tax or tax greenmail at nearly 80 percent.

My understanding of the testimony offered to this committee in the past has been there is virtually no greenmail being paid in America today, or at least folks who I have asked said there is very little being paid, and the reason is, I think, that we just taxed it out of existence.

Mr. ANTHONY. I applaud the gentleman's effort for bringing that to the Congress' attention, and I would just note that if the record can be established that there are still some abuses out there, we ought to take a continued close look at it.

Mr. CUNNINGHAM. There may be a small problem with the greenmail section, and that is if the greenmail payment is based on an offered stock price, it would probably not be greenmail payment.

You remember in the Oversight Subcommittee, Boone Pickens said that he always got the highest offered price for a stock, and therefore never accepted greenmail. One of the problems with the provision may be that if it is a publicly offered price, even though one person only gets the stock at that price, for purposes of the code, it is not considered greenmail. But since only the raider gets that benefit, it might be looked at as greenmail, so there might be something to look at.

Mr. DORGAN. We are watching that carefully to see whether there is any way around it.

There is a kind of arrogance in this country that I have not seen. The last 6 or 8 years we have had people come to this committee room and they have said, essentially, on the record and they certainly are explicit off the record, "Look, it does not matter what you do. We will find a way around it."

Twenty or 30 years ago you did not hear that in this country, but there is sort of a brazen arrogance among some in this country who figure out that they are not interested in the spirit or the intent of public policy as it is related in law. They are interested in trying to figure out how you get around these things.

I hope the attitudes and times will change in those areas, but at least with respect to greenmail, we do not now know of instances in which greenmail is being paid to the extent that it is and identified—it is being taxed to death, and this is one instance in which a confiscatory tax, I think, is healthy for America.

Greenmail was immoral and wrong and I think we have taken some policy steps to deal with.

Mr. Cantor, thank you very much for you testimony. We appreciate your willingness to be here today.

The committee will next hear from Mr. David Bernstein, partner, Rogers & Wells, New York, and Mr. Hugh Calkins, a partner of Jones, Day, Reavis & Pogue from Cleveland, OH.

If Mr. Bernstein and Mr. Calkins would please come forward and take their place at the table.

Mr. Bernstein and Mr. Calkins, we will include your entire statement as a part of the permanent record. We would urge that you summarize for us today, and we would first call on Mr. Bernstein, partner of Rogers & Wells in New York.

Mr. Bernstein, welcome to the committee.

STATEMENT OF DAVID W. BERNSTEIN, ESQ., PARTNER, ROGERS & WELLS, NEW YORK, NY

Mr. Bernstein. Mr. Chairman, thank you.

I am a lawyer who specializes in merger and acquisition transactions and in financing transactions. I guess I really speak from the trenches when I talk about the LBO-type transactions.

I think I ought to start by stating that I don't think LBO's are a bad thing. And I think that, by and large, they probably have an overall positive effect.

In terms of the acquired businesses, they tend to lead to a slimming down, and that tends to make them more efficient. Of course we know that may create temporary dislocations in terms of jobs. But I don't believe anybody in this room would advocate that we should let American industry get sluggish and inefficient in order to maintain jobs which aren't needed.

We are in competition throughout the world, and American industry must be able to compete effectively.

There has also been concern expressed about the sociological, if you like, problems to workers when their businesses are bought as well as when their divisions and subsidiaries are sold. I believe that's a myth. Within the past 18 months, I have personally been involved in four separate transactions involving businesses which were sold in order to pay off part of the acquisition debt of larger leveraged buyouts. One of these transactions was, at the time, the largest ESOP purchase that had ever taken place, the Avis, Inc. purchase, which has worked out, by any standard, as an extremely attractive transaction for the employees of Avis and for the company itself.

In each of the transactions I have worked on, I believe it's fair to say that the employees of the divested subsidiary division have been delighted to get out from under a major corporate umbrella and able to operate on a more free standing basis.

From the point of view of public investors, I would also think that the leveraged buyout movement should be seen as a fairly favorable thing. People are trading common equity securities for, fixed income securities, and that ought to, by and large, be a conservative and healthy movement for the investing public. It also, by the way, may reflect concerns over whether our stock markets are really as liquid as we thought they were, concerns which were heightened obviously on October 19, 1987.

But there is a potentially serious problem with substituting debt, whether it's high yield debt or low yield debt for equity. That problem is that in difficult times equity holders cannot force the company into bankruptcy; creditors can.

But it seems to me there's a relatively simple solution to this. There is among the available tools for financing the use of preferred stock. Preferred stock, from a financial point of view, but for the tax effects, looks like debt and feels like debt. Its dividends look like interest and the redemption feature can look like principal repayment. It can provide all the economic needs of subordinated high yield debt. In fact, investment bankers tend to use the same people to market preferred stock that they use to market high yield debt. But there is a very significant difference between the two, and that is the tax treatment of the payment to the holders of these different securities.

A payment of interest is deductible to an issuer of debt. Dividends paid on preferred stock are not deductible. Interest is taxable to a recipient of interest. The dividends received deduction, which permits corporate holders of preferred stock to sharply reduce the tax, is only available to corporate holders of preferred stock. In short, what should be two virtually identical pieces of paper turns out to be very, very different because of the tax laws.

Now, because of what I have said, it is obvious that I support a number of the options which would treat the taxation of dividends on equity, or at least on preferred stock, in the same manner as the taxation of interest on debt. But the options run the entire spectrum—from those who would do this by taking away the tax benefits for debt including the deductibility of interest to those which would have the dividends paid on equity investments taxed as debt.

I strongly urge the latter is the proper way to proceed because it is the one way we can remain competitive in world markets.

Thank you.

[The statement of Mr. Bernstein follows:]

TESTIMONY OF
DAVID W. BERNSTEIN
OF
ROGERS & WELLS
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
REGARDING
TAXATION OF LEVERAGED ACQUISITION FINANCING
MAY 16, 1989

Mr. Chairman, members of the Committee,

I appreciate this opportunity to testify with regard to a series of options being considered which, in effect, would modify the tax treatment of interest on debt incurred in connection with leveraged acquisitions of businesses, and proposals to modify the tax treatment of dividends or stock issued in connection with acquisitions.

I am a partner in the law firm of Rogers & Wells. I specialize in merger and acquisition transactions and financing transactions. Therefore, what I have to say can probably be characterized as coming from the trenches. However, perhaps in part because of the nature of my professional practice, I also have a great interest in capital formation and related subjects.

Let me start by saying I do not believe highly leveraged acquisitions are a bad thing. I believe overall they probably have a positive effect.

From the point of view of the acquired businesses, leveraged acquisitions frequently lead to a slimming down, which tends to make the businesses more efficient. I, of course, am aware that slimming down of businesses leads to temporary dislocation of people. However, I don't think there is a person in this room who would advocate that we should let American industry get sluggish and inefficient in order to maintain jobs which aren't needed. Countries around the world are competing with the United States in attempting to produce higher quality, less expensive products. Inefficiencies which make us unable to win that competition seem to me to pose a much more serious threat to the United States job market than do the temporary problems caused by slimming down businesses.

Concern has also been expressed about the fact that leveraged acquisitions often lead to sales of subsidiaries and divisions in order to reduce acquisition borrowings, which it is claimed disrupt the lives of the employees of the divisions and subsidiaries which are sold. I believe that is a myth. I have within in the last year and a half worked on four transactions involving companies which were sold to provide funds with which to pay down acquisition indebtedness. In each instance the employees were delighted to be out from under a large parent group and able to operate more as a freestanding business. Surely the disruption of being sold out of a large corporation is far less than the change encountered by employees of an acquired company when they are first forced to conform to the corporate culture of a major corporate group.

In terms of the investing public, it seems to me that, with one exception, leveraged acquisitions should be viewed as a very favorable event. In effect the recent wave of leveraged acquisitions has moved a large amount of investor money from common equity securities to fixed income securities. This should be a conservative and healthy thing for the investing public. It may also reflect investors' concerns, reinforced by the events of October 19, 1987, that our equity markets are not as liquid as they have been thought to be.

There is, however, a potentially serious problem with converting a large amount of equity into fixed income debt. The problem is that, in difficult times, equity holders cannot force a company into bankruptcy -- debt holders can. Therefore, the wave of leveraged acquisitions probably has increased the vulnerability of a number of companies to a severe downturn in the economy.

There is, however, a solution to this. The solution is to create a climate in which the high yield portions of leveraged acquisition financing can be obtained through sales of preferred stock instead of high yield debt. Preferred stock is an equity interest, but it can be structured to have virtually the same financial attributes as debt. Its dividends act like interest, and mandatory redemptions at specified dates perform the same function as required principal payments. In fact, in many investment banking firms preferred stocks and high yield debt securities are marketed through the same high yield securities group. However, the remedy of preferred stockholders for a corporation's failure to pay dividends or to meet redemption obligations is that the preferred stockholders often become entitled to a degree of control over the corporation and the corporation is prohibited from paying dividends on common stock. However, preferred stockholders normally cannot force a company into bankruptcy.

The principal reason preferred stock is not in many cases a good substitute for debt is that it is treated very differently for tax purposes. Interest is deductible to the issuer of debt. Dividends paid on preferred stock is not. Corporate holders of preferred stock are entitled to a dividends received deduction. With a few exceptions, holders of debt are not able to deduct any portion of the interest they receive.

In view of what I have said, it should be obvious that I support the concept, embodied in a number of the options being considered by this Committee, of changing the tax treatment of preferred stock and debt issued to finance leveraged acquisitions so they will be taxed in the same manner. However, my support for those options is not universal. A number of the options being considered would create equal treatment of debt and preferred stock by making interest on high yielding acquisition indebtedness wholly or partially non-deductible. This would not be healthy. What it would do is make it more costly and difficult for an American company to acquire another American company than it may be for a foreign company to acquire an American company. While I do not oppose foreign investment in American companies, I would not want to see American companies made unable to compete with foreign companies in the acquisition market. However, tax legislation which eliminates or sharply reduces the deductibility of interest paid on acquisition indebtedness but continues to tax receipt of that interest will almost surely have that result.

I am aware that the options being considered also include proposals which would increase the tax burden on foreign persons engaging in leveraged acquisition of American companies. However, the most effective of these proposals require a reevaluation of our withholding system and may even require renegotiation of tax treaties. I do not think these proposals are a likely cure for the problems which would be created in reducing or eliminating the deductibility of interest on acquisiton indebtedness.

I thank you for giving me the opportunity to make these comments. Attached to the text of what I have said today is an Appendix containing my specific comments about a number of the options being considered by this Committee.

Thank you.

APPENDIX TO TESTIMONY
OF DAVID W. BERNSTEIN

Comments Regarding Options Being Considered

A. Comments Applicable to all Legislative Options:

I do not believe an appropriate purpose would be served by treating debt issued in connection with large acquisitions differently from debt issued in connection with small acquisitions. I also do not believe any appropriate purpose would be served by treating purchases of wholly owned subsidiaries or closely held corporations differently from purchases of public companies. Finally, I do not believe any appropriate purpose would be served by treating indebtedness issued in connection with hostile takeovers differently from indebtedness issued in connection with friendly transactions.

B. Options Modifying the Current Tax Treatment of Corporate Interest.

1. As I said above, I do not believe any appropriate purpose would be served by treating indebtedness incurred in connection with the acquisition of companies in hostile tender offers differently from indebtedness incurred in connection with friendly transactions. Indeed, a successful hostile acquisition may be the strongest indication that assets are being underutilized and that new ownership may be able to improve efficiency.

2. I believe that to deny an interest deduction for debt incurred to finance mergers found by the Federal Trade Commission to have a substantial adverse effect on employment would impose added regulation and controversy. It would also substitute governmental business judgment for corporate business judgment, which would not necessarily be appropriate, particularly because of the intense political pressure which can be expected in many instances. The principal effect of the proposal would be to discourage the acquisition and revitalization of poorly managed companies.

3. To use the tax laws to discourage the issuance of high yield bonds would seriously adversely affect the ability of American companies to compete in the acquisition market. Not only are high yield subordinated debt issues often the source of a portion of the financing for leveraged acquisitions, but the existence of that subordinated debt makes it possible to obtain senior debt for another portion of the financing. However, if preferred stock were taxed in the same manner as debt, in many instances, preferred stock could be used, instead of debt, to provide the high yield junior portion of the financing of leveraged acquisitions. Therefore, as discussed in my principal comments, I do not think the tax laws should be changed to discourage the use of high yield debt securities. I think the tax laws should be changed to encourage the substitution of preferred stock for high yield debt securities.

4. and 5. Each of these options attempts to achieve a balance between the tax treatment of debt and equity so the two will be substantially equivalent. I favor this concept. However, I do not think it is necessary to alter the tax

treatment of acquisition debt. What is needed is to alter the tax treatment of preferred stock issued in acquisitions so it will be treated in the same manner as debt. That would mean making dividends deductible to the issuer and eliminating the dividends received deduction with regard to preferred stock issued in acquisitions. This should be substantially revenue-neutral. It would only encourage the use of preferred stock in place of debt by treating the dividends paid on such preferred stock in the same manner as interest for tax purposes. The problem with the option in paragraph 4 is that it would make both acquisition debt and acquisition preferred stock noncompetitive with borrowings by foreign companies in their home countries. The option in paragraph 5 would, to the extent it in effect compels distribution of interest deductions to shareholders, discourage corporations from making acquisitions, unless they could structure their corporate groupings so that, through use of nonconsolidated tax reporting or other devices, the benefit of the interest deduction and the cost of the interest obligation could be brought together. Thus, at worst the option in paragraph 5 would make it harder for American companies to bid against foreign companies to acquire American businesses. At best the option in paragraph 5 would do little or nothing.

6., 7. and 8. The proposals in paragraphs 6, 7 and 8 all would eliminate or reduce the deductibility of interest in highly leveraged situations. As discussed above, this would put American companies at a serious competitive disadvantage in the acquisition market.

9. Deferring the deductibility of interest expense on original issue discount obligations until the interest amounts are actually paid would make it less attractive for American companies to use discount obligations. However, in part, the ability to amortize original issue discount, and receive tax benefits before interest is paid, is a windfall. Furthermore, not all countries recognize the concept of amortization of original issue discount for tax purposes. Accordingly, the option in Paragraph 9 may be worth pursuing.

C. Options Modifying the Current Tax Treatment of Equity Distributions Made by Corporations.

1., 2. and 3. At least with regard to preferred stock issued in acquisitions, I do not believe the proper approach is to give a credit or exclusion to recipients of the dividends. I believe the dividends should be deductible to the issuer in the same manner as interest on acquisition debt, and the recipients should be taxed in the same manner as recipients of interest paid on acquisition debt.

D. Options Relating to Investment Banking Fees.

1., 2. and 3. These options all seem to proceed from an assumption that investment banking fees are too high and an assumption that the tax laws are the proper way to curb this. Without commenting on whether investment banking fees are or are not too high, the idea of using excise taxes to set charges by private individuals appears to me to pose severe problems. Would Congress next impose an excise tax on baseball players' salaries in excess of $250,000 per year, or on plumbers' charges in excess of $20 per hour? The investment banking world is already highly regulated. If Congress is to consider imposing limitations on investment banking fees, the Committees which oversee the securities industry, not the Committees which consider tax legislation, would seem to me to be the appropriate place for this consideration to take place.

E. Options Relating to the Tax Treatment of Foreign Persons and to Issues of Foreign Investment.

1. This option appears to require equating foreign currency interest rates with United States dollar interest rates, and then trying to determine which portion of the foreign currency borrowings are "high yield," in order to start applying non-deductibility concepts discussed in Section B. That probably is not possible, among other things because it assumes foreign currency financings are structured in the same senior-junior fashion as many United States leveraged transactions. Insofar as I am aware, at least to date, that is not the case in most countries.

2. and 4. Both these options contemplate a resumption of substantial withholding from interest on foreign borrowings and renegotiation of a large number of tax treaties. If this is to be considered, it should be considered as a matter of national tax policy, not as a band-aid to help equalize American companies and foreign companies in leveraged acquisitions.

3. I am not in a position to comment on this proposal.

5. I believe there is logic to trying to tax foreign persons on gain on liquidation of businesses or sales of businesses. However, the problem with attempting to withhold from gain is the need to determine basis (which perhaps could be cured by presuming all proceeds are gain unless the foreign recipient files a form reporting its basis). The problem with attempting to tax liquidation or sale proceeds as dividends is that it does not give credit for basis, and therefore can have the effect of taxing proceeds of sales which involve little or no gain or which involve losses.

F. Options Modifying the Tax Consequences Relating to Certain Corporate Financing Transactions.

The options under this caption reopen what appears to have become a biennial reconsideration of the fundamental concept of how corporate acquisitions should be taxed. I believe each of them requires a great deal of study before it is even seriously considered.

G. Options Relating to Employees Stock Ownership Plans (ESOPs).

1., 2. & 3. Over a period of years the tax laws were modified to the point where, through ESOPs, it became possible for employees actually to purchase the companies which employ them. Many of the significant aspects of the law relating to leveraged purchases by ESOPs were introduced in the 1984 and 1986 tax legislation. I was involved personally in the acquisition of Avis, Inc. by an ESOP it formed. When it occurred this was the largest acquisition in history of 100% of the stock of a corporation by an ESOP for its employees. The Avis transaction appears to have resulted in major improvements in efficiency and morale. Also, in the fifteen months between the September 1987 completion of the transaction and January

1989, the appraised value of the stock held by the Avis ESOP increased from $5.22 per share to $15.47 per share. As I understand it, these are precisely the benefits sought by the changes in the tax laws which encourage ESOP purchases. If there is any type of ESOP transactions which seem to be controversial, it is the placing of sizeable minority blocks in ESOPs as anti-takeover measures, not leveraged ESOP purchases of entire corporations. Having achieved the objectives it sought through ESOP legislation, I suggest Congress should wait a few years before trying to change what it has accomplished. One is reminded of the old admonition "If it ain't broke, don't fix it."

H. Miscellaneous.

This Section basically proposes to use the tax laws to enforce, or change, the rules in the Federal securities laws for tender offers and leveraged buyouts. If Congress wants to change the laws relating to takeovers or leveraged acquisitions, that should be addressed by the Committees which oversee the Federal securities laws. I strongly object to the concept of the tax laws being used to create a second body of securities laws.

Mr. DORGAN. Mr. Bernstein, thank you very much.

Next we will hear from Mr. Calkins.

STATEMENT OF HUGH CALKINS, ESQ., PARTNER, JONES, DAY, REAVIS & POGUE, CLEVELAND, OH

Mr. CALKINS. Thank you, Mr. Chairman. I appreciate the opportunity of speaking with the committee today.

I am a tax lawyer, who also practices in the corporate field, and have done so for three or four decades in Cleveland, and recently have been observing the takeover merger, et cetera, phenomena.

I would like first to comment on Mr. Wilkins' testimony because I really think that is a good deal of it was addressing the wrong issue. He was testifying as if the issue is: are takeovers good or bad? I don't think that is a question to which there will ever be a reliable answer. Some are good and some are bad, and no legislature can ever draft a law that says good takeovers should take place and bad takeovers should not. The responsibility of the legislature is to look at the playing field. Is it level or is it tilted?

Clearly, today, the playing field in the debt equity area is tilted. It is tilted so drastically in favor of debt that I tell my corporate clients who (*a*) are paying Federal income tax, and (*b*) are not effectively controlled by a family or employee group, that they have only two choices. Either they will restructure themselves by issuing debt and retiring shares, thereby getting out from under most of their Federal income tax burden, or somebody else will do it for them.

The advantage to taking the dollars that now flow to the Treasury from a taxpaying corporation and capitalizing them into a higher price per share is so great that it is irresistible. I frankly do not understand why the Treasury Department looks instead at the question, "Are takeovers good or bad," instead of looking at whether the tax law, which is under their responsibility is creating a pressure in one direction or the other. It seems to me to be obvious that it is creating an essentially irresistible pressure in favor of corporations getting out from under the corporate income tax, capitalizing that money into higher stock prices for somebody, and using debt to run their business to the extent they possibly can.

Now, all that has been compounded by Michael Milken's pointing out to the world that lenders can achieve safety in owning highly leveraged, highly risky debt the same way they used to do it with stock. They can achieve safety by owning a lot of different companies' debt, as well as by policing their borrowers' balance sheets to see that the equity ratios are appropriate.

Therefore, it seems to me that the assignment for this committee is to find a way to reduce the pressure toward debt. It is, after all, created by laws that Congress has enacted. In a very real sense, Congress is creating the pressure for the acquisitions and takeovers that occur today.

I distributed with my testimony a copy of a guest editorial I recently wrote in Tax Notes, which contains a table and a calculation. The calculation says that whenever you read in the morning newspaper that there has been a $10 billion takeover, $1 billion is coming from the taxpayers through the U.S. Government. I think the United States Government should get rid of that 10-percent subsidy. It can. Here is the package.

This is a revenue neutral package which will end up with substantial integration. The package consists of a shareholder credit for dividends received, paid for by reductions in the revenue loss due to interest, and a windfall tax on unrealized capital gains aimed at the increase in stock prices that will probably result from adopting an integration proposal.

The first of the proposals is to exclude as a deduction and from income the portion of interest paid by anybody which is only an inflation adjustment. That's what's spelled out in the guest editorial. If 4 percent is the inflation adjustment, the borrower can only deduct the interest above 4 percent, the lender will only take into income the interest above 4 percent.

The second proposal which you are going to hear more about tomorrow so I won't dwell on it today. It is simply to treat as equity any junk bond on which the interest rate is 5 percentage points higher than the Federal rate.

The third proposal, which may be be the most controversial of all, is to impose a tax on corporate interest income of pension funds, charities, and foreigners at a fairly low rate. I suggest something like 10 percent. I ask you to take into account the fact that interest is not truly regarded as an expense of a business, it is a way in which the earnings of the business can reach the security holders who have invested money in it. It is wrong for a pension fund to get 16 percent interest income from a business and pay no tax on it.

When NYU tried to get the earnings of the spaghetti factory without tax, Congress changed the law to impose an unrelated business income tax. My proposal is an unrelated business interest income tax imposed on tax-exempt and foreigners.

The recapture tax proposal is a way, again at the low rate, of trying to respond to the objection made to integration that it will make all present shareholders richer unjustly by increasing the value of their shares. Let's impose a tax on that increase in shares value, unrealized as well as realized. That will provide some more money and respond to that objection.

Thank you, Mr. Chairman.

[The statement of Mr. Calkins and attachment follow:]

UNITED STATES CONGRESS
House of Representatives
Committee on Ways and Means
Hearing on LBOs and Related Transactions
Tuesday, May 16, 1989

Prepared Statement of Hugh Calkins to Accompany Oral Testimony

My name is Hugh Calkins. I appear in my personal capacity. For your information, I am a partner in the Cleveland office of the law firm of Jones, Day, Reavis & Pogue. I practice primarily in the fields of taxation and corporate matters. I am a past Chairman of the Tax Section of the American Bar Association and have twice been a member of the Advisory Group to the Commissioner of Internal Revenue. I do not speak for any of these organizations in this statement.

My advice to the Committee is that it approve and recommend to the House for adoption in 1989 a revenue-neutral package of federal income tax changes which will level the playing field on which decisions to carry out LBOs and corporate restructuring replacing equity with debt are made. I believe that a revenue-neutral, workmanlike package achieving this objective can be designed and that it is well worth the additional complexity which it will, regrettably, inject into the income tax law.

The need for a level field.

Some witnesses appearing before you have created confusion by pointing out that the tax pressure to replace equity with debt is lower now than it was a decade ago when LBOs and corporate restructures were much less common than they are today. That observation is true, but it is no more relevant than to tell a homeowner whose bathtub pipe has burst that city water pressure has been reduced a little in recent years. It is obvious to anyone who thinks about the subject that a principal effect of most LBOs and restructuring is to capture for the investor the stream of corporate earnings which formerly was flowing to the Internal Revenue Service on account of the corporate income tax law. It is the capitalization of that stream which, in large measure, makes it possible for the acquiror in an LBO and the company itself in a restructuring to offer a substantial premium over the price at which the stock market values the company's shares when the earnings behind the shares are subject to combined federal and state corporate level taxation at nearly a 40% rate.

The tilt in the playing field is so great that I believe it is fair to state that no corporation in the United States today which does not have nearly a majority of its voting power in closely held hands can expect to avoid a takeover if it is a substantial payer of corporate income tax. If it does not restructure to capture that cash flow stream for the benefit of its investors, it will be taken over by someone who will capture it.

I believe that, more often than not, restructuring and buyouts are damaging to the economy. In my experience, the availability of capital to meet business plans is critical to the internal growth of businesses. Capitalizing the federal income tax stream for the benefit of current investors in the business, and leaving company management in a position in which it must scrape to meet debt requirements, substantially interferes with internal business growth.

A revenue neutral way to achieve integration.

A number of the witnesses who have appeared before you have suggested that the playing field can be narrowed if Congress will introduce in this country an "integration" system which will mitigate or avoid the present double tax on the earnings of corporations taxable under Subchapter C -- that is, the tax paid at both the corporate and the shareholder levels upon the distributed earnings of all publicly held and most of the larger privately held corporations in this country. These witnesses have not, however, suggested a way in which the double tax can be mitigated or eliminated in a revenue-neutral tax bill without raising tax rates. My purpose today is to suggest how this can and should be done.

A level playing field in the debt equity arena can be achieved by a revenue-neutral tax bill if the revenue loss from interest investments is reduced by the same amount as the double tax burden on corporate equity is relieved.

The current revenue loss associated with interest is substantial because in the marketplace borrowers generally have higher tax brackets than lenders. Pension funds, other tax exempt entities, and foreigners are well represented among lenders because none of them pay income tax on interest income if it is not associated with a business activity. Some borrowers cannot deduct interest because they are in net operating loss positions, but that is exceptional, since most such borrowers contrive to refinance with preferred stock and thereby pass the interest deduction on to an intermediary which can use the deduction.

There are at least three reasonable ways to reduce the revenue loss associated with interest. Each is appealing in its own right and would have been adopted long ago but for the additional complexity which each proposal would create and the long standing traditions in this country favoring borrowers.

Eliminate the inflation adjustment from interest expense and income.

The broadest-based method of reducing the revenue loss associated with interest is to confine the interest deduction and interest gross income to the portion of interest which is the real compensation for the use of money. The remaining portion of interest is the adjustment for inflation. In economic truth, that latter portion is neither an expense to the borrower nor income to the lender; it is only an accounting adjustment which offsets the borrower's gain from the reduction in the real dollar principal amount of the loan due to inflation and the lender's real loss resulting from that inflationary reduction in principal amount. Because in our present law we continue to treat the inflationary adjustment as a deduction to borrowers and income to lenders, and because the borrowers are in a higher tax bracket than the lenders, the Internal Revenue Code is providing a very large subsidy to borrowing transactions in the United States. I have recently prepared a paper developing this subject at greater length, copies of which are submitted herewith for distribution to any interested Members. It can be found in the March 6, 1989 issue of Tax Notes at page 1267.

Treat high rates of interest as dividends.

The second reasonable and logical way to reduce the tax loss associated with interest is to recognize that very high rates of interest are associated with sufficiently high levels of risk that the investment should be considered equity rather than debt. For example, your Committee may wish to recommend that so-called interest at rates which are more than, say, 5 percentage points above the federal rate are to cause the debt instrument to be treated for tax purposes as equity. If you wish, this proposal could be limited to debt issued by publicly held enterprises, although I do not personally recommend your creating an additional distinction disadvantaging that beleaguered species in comparison with privately owned corporations and partnerships.

Impose an "unrelated business interest" tax on tax-exempt entities and foreigners.

In connection with my third suggestion for reducing the tax loss associated with interest, I respectfully suggest that the Committee reflect on the fundamental change which has taken place in the last decade with regard to the distinction between equity and debt. In earlier years, the permanent capital of a business firm was predominately equity. Indebtedness was incurred up to a ratio in which the debt rarely exceeded 40% of the total equity and debt capital. Most large business loans were extended at interest rates not far from the prime. For most of this period, personal income tax rates were substantially higher than corporate rates.

Now this has changed. The corporate tax rate is higher than the individual rate. Lenders seek security through diversifying their loans, rather than by policing the debt equity ratios of their borrowers. Interest rates have been raised to reflect the greater risk. One or more layers of debt capital, nearly as much as the equity capital, is at the risk of the business.

Tax exempt lenders who own spaghetti factories pay income tax on the income of this unrelated business. Tax exempt lenders who invest in the shares of a spaghetti factory company have their dividend stream reduced by the federal income tax paid by the company. Why should holders of bonds, especially junk bonds, of spaghetti company factories receive their share of the business income with no tax being paid at either the corporate or the investor level?

I suggest that the fundamental principle is clear: all business enterprises should pay tax on their earnings. When the business organizes its affairs so that substantially all of its earnings pass (possibly through intermediaries) to tax exempt or foreign investors, that income stream should be subject to an appropriate tax. It has proven to be extraordinarily difficult to devise a means to impose that tax by denying a deduction at the borrower side without sweeping into the denial corporate debt which the Committe does not intend to make subject to the denial. Therefore, I propose that the Committee consider imposing a tax, which might be called an "unrelated business interest" tax, on the junk bond interest income of pension funds, charities and, to the extent treaty negotiations will permit, foreign lenders.

Recapture of windfall gain.

In addition to these three sources of revenue loss reduction on the interest side, I suggest that this Committee consider a recapture tax on the equity side. The tax which I am proposing would go far to eliminate the objection often made to introducing a system for integrating corporate and individual tax through dividend relief. That objection is that the reduction in the double tax on corporate earnings paid out as dividends will be capitalized into the value of outstanding shares of stock and will provide a windfall to the owners of those shares, who are primarily concentrated in the top quintile of the income distribution. My proposal is that a tax of appropriate size, such as 10%, be imposed on the unrealized gains, and, in addition to the capital gains tax, on the realized gains, reflected in shares of stock during the period in which the Committe determines that the windfall rise in stock price levels will occur. It could start whenever the market begins a rise in anticipation of enactment and end six to twelve months after enactment. The tax admittedly would reach some stock price increases attributable to company business successes, and it would be attacked as unfair. Your Committee's response would be that rough justice is better than untaxed windfalls to the wealthy. Application of this tax to unlisted shares would be very difficult, and for simplicity I propose that it be limited to listed shares.

Credit system of integration.

Thus, the field-leveling proposal which I am advancing has four substantial revenue elements. Whatever revenue they would yield would then be invested in the integration of the corporate tax and the individual tax on dividend income. I much prefer a credit system, such as that used in the U.K., to a deduction for dividends paid. To me, the latter has the serious objection that the tax exempt and foreign entities which are coming to own an increasing share of U.S. corporation equity would pay no tax, directly or indirectly, on their portion of the corporate earnings.

Conclusion.

What are the reasonable objections to the package of proposals I have advanced? There are two that concern me in particular, and they are related. The first is that they would constitute a substantial additional change in the tax law. Coming on the heels of the Revenue Acts of 1981, 1982, 1984, 1986, 1987, and 1988, these additional changes would further stretch a revenue system close to breakdown. Secondly, and relatedly, several of the specific concepts would in implementation almost certainly turn out to be complex, and I consider our tax system to be nearly inadministrable as it is.

Nevertheless I believe that the present disparity in the tax treatment of debt and equity, exacerbated by fixing the corporate tax rate above the individual tax rate for the first time in our modern tax history, is so great as to make the continued vitality of strongly capitalized corporations improbable. We depend on them heavily for international competitiveness. I consider it urgent that this country level the debt-equity playing field. I, for one, am prepared to cope with further change and additional complexity if that is the best way in which a level field can soon be achieved.

A REVENUE NEUTRAL BILL TO ACHIEVE A LEVEL FIELD

Reduce revenue loss from interest by:

- Excluding inflation adjustment,
- Treating very high interest debt as equity, and
- Taxing "unrelated business interest income" of tax-exempts and foreigners.

Capture windfall gains from integration by short-lived tax on unrealized gains in listed shares of stock

Use these revenue increases to pay for partial integration using credit model.

guest editorial

THE INFLATION SUBSIDY IN INTEREST

by Hugh Calkins

Hugh Calkins is an attorney with Jones, Day, Reavis & Pogue in Cleveland, Ohio. The views expressed in guest editorials do not necessarily reflect the views of Tax Analysts.

The guest editorial page is open to any person who wishes to express an opinion on tax or fiscal policy. It is our hope that the views expressed in our guest editorials will contribute to the development of a sound and administrable system of taxation. Please address proposed guest editorials to the editor.

When bidders pay billions of mostly borrowed funds to acquire their targets, few observers have noticed that the United States government is contributing toward the purchase price an income stream worth approximately 10 percent of the purchase price.[1] This subsidy to corporate buyouts and recapitalizations, and to much other borrowing, comes about because under our tax law a borrower is allowed to deduct not only the lender's charge for the use of money, but also the portion of interest "expense" which is the adjustment for inflation. Such adjustment is not a cost of money and is not in economic effect an expense. This deduction of a nonexpense constitutes a subsidy whenever the direct or indirect lender is a tax-exempt or foreign entity which does not pay tax on the corresponding interest "income," or a lender which pays tax at a lower rate than that of the borrower.

In the course of his testimony before the Senate Finance Committee hearings on LBOs on January 25, 1989, Professor Lawrence H. Summers of Harvard University used the following table, displaying Federal Reserve estimates of ownership of corporate bonds and Professor Summers' "crude" estimates of effective tax rates. It reveals the extent of the subsidy to be an annual subvention equal to the inflation rate (roughly four percent at this time) multiplied by the average tax rate differential (27 percent for corporate borrowings), or a little more than one percent. Capitalizing the annual subvention with a factor of 10 yields the 10-percent Federal subsidy approximation I have suggested.

Effective Tax Rates on Interest Receipts from Corporate Bonds

	Annual Interest Receipts ($ billions)	1988 Effective Tax Rate (Percent)
Households (Untaxed)	2.9	0
Households (Taxed)	5.0	28
Foreigners..........................	13.3	0
Commercial Banks	6.0	15
Savings and Loans	3.2	18
Mutual Savings Banks	1.2	6
Life Insurance Companies	32.9	20
Private Pensions	13.3	0
St. & Local Govt. Retirement Funds	11.4	0
Other Insurance	4.6	20
Mutual Funds	4.6	28
Security Brokers and Dealers	1.6	34
Total/Weighted Average Tax Rate	$105.0	7.3

Sources: Interest receipts are from the Federal Reserve Board, *Flow of Funds*. Tax rates for industries are from Tax Analysts, *Quantifying the Impact of the Tax Reform Act of 1986 on Effective Corporate Tax Rates*, 1986. Rates for households, foreigners, and pension funds are based on 1988 tax law.

The table discloses that 41 percent of interest receipts from corporate bonds are earned by pension funds, state and local government retirement funds, holders of tax-exempt bonds, and foreigners, all of whom have a virtually zero rate with respect to U.S. interest receipts. (Pension funds are taxable to retired persons on distribution, but this tax is deferred so long as to have little present value.) Another 47 percent of interest is earned by insurance companies, commercial banks, and others whose effective rate of tax is 20 percent or less. Overall, the weighted average effective tax rate paid by the recipients of corporate bond interest is only 7.3 percent. Thus, if we assume an inflation rate of four percent, and a corporate borrower in the top corporate bracket, the corporation with an average borrowing is subsidized to the extent of 1.07 percent (.267 x .04) of the principal of the borrowing each year.

There is a national cry for stability in the income tax system. Six major revenue acts in seven years are too many for taxpayers, tax practitioners, and tax administrators to absorb. Some say it is better to tolerate any deficiencies in the present system rather than to institute yet another change; all agree that only the most pressing considerations warrant a new effort better to define the income tax base.

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[1] This subsidy is part of the larger income stream, represented by the corporate income taxes paid prior to, but not after, the transaction, which is the essential fuel for cash purchases and recapitalizations.

The difficulty the advocates of stability are encountering is that many individuals and groups are identifying pressing considerations which they believe warrant a particular change in the tax law. President Bush has indicated that his list includes restoration of a preferred rate for capital gains and a strengthening of the preference for research and development expenditures. I believe that, in a country in which government, individual, and business borrowing is climbing dangerously, eliminating the significant existing Federal subsidy for borrowing (and excluding from taxable income the corresponding inflation adjustment) is sufficiently urgent to warrant a change in law.

The change which I have in mind can be stated simply and, I believe, introduced with only moderate complexity. Here are the principal elements:

- The proposal is applicable to all interest, whether incurred by a corporation or an individual, to finance a LBO or to build a house.
- The reduction in the deduction, and the exclusion from income, would be based on the actual inflation rate in a recent quarterly period, and not on an anticipated inflation rate. The reduction and the exclusion take place each year, as interest is paid. Their purpose is to eliminate from expense and income an amount which is in fact an adjustment of principal. That amount is more clearly determined for any year by the actual inflation rate in that year than it would be by any estimate of what inflation will be over the life of the loan or the current decade. A recent quarterly period, rather than the current quarter, is proposed for administrative simplicity.
- My hope is that it will not be necessary to index rentals. The value of the residual rises with inflation, and to some extent offsets the tax subsidy the lessee now receives and the tax burden the lessor bears. On the other hand, the present worth of the inflationary value of the residual at the inception of most leases may be so much smaller than the present worth of the inflationary element in the rental stream that indexing rentals may be necessary. If so, the simplest way I have thought of to determine the adjustment for rentals is to require the parties to agree on a value of the rented property at the inception of the lease. The inflation rate each year as the lease progresses then would be applied to that fair market value to determine the amount of the deduction adjustment and income exclusion. If agreement does not occur, the lessee and lessor each would be required to attach other evidence of value, calling attention in the tax return to the lack of agreement.
- The basis of assets would not be adjusted for inflation, although the depreciation deduction itself probably should be. See Durst, *Inflation and the Tax Code: Guidelines for Policy Making* (to be published shortly in *Minnesota Law Review*). Asset basis adjustments are very complex, and the restoration of a preferential rate for long-term capital gains will mitigate the effect of inflation on income from sale of capital assets.
- The information return system would be the principal means of advising borrowers and lenders of the portion of the interest which was nondeductible and excludable. This would place an additional programming burden on the business firms that now furnish these information returns. That appears to me to be an inevitable price for the improvement in the law which I am suggesting.
- Some interest is paid and received between parties neither of whom is a part of the information reporting system. According to Charles E. McClure, Jr., who was Deputy Assistant Secretary of the Treasury for Tax Analysis at the time, this fact was considered in 1984 to represent an administrative problem of such magnitude that the Treasury's initial proposals (Treasury I) rejected the "actual recent inflation" approach and adopted a "six-percent real interest approximation" approach.[8] With deference to the Treasury, I do not find the problem as difficult. Where a taxpayer cannot readily determine the inflationary element in a portion of income or expense, the taxpayer would be permitted to use an economically unattractive safe harbor. For instance, a borrower or lender, uncertain when in the year interest was paid, received, or accrued, would exclude from deduction the highest rate, and exclude from income the lowest rate, of inflation applicable to the quarterly periods of the year.

An important question which I am not competent to answer is the effect of adoption of this proposal upon interest rates. The only discussion of that subject by persons competent to comment on it which I have found is the chapter "Indexing the Tax System for Inflation" by Daniel Halperin and Eugene Steuerle, published in a volume entitled *The Uneasy Compromise*, Aaron, Galper & Packman, Editors (Brookings Institution, 1988). At page 371, they include the following paragraphs:

> Some have noted that indexing for debt is less important than indexing for other assets. Because the treatment of the debtor and the creditor is reciprocal, the parties can in effect compensate for the lack of indexing for anticipated inflation.
>
> For example, suppose the tax rate is 33 percent and the expected rate of inflation is four percent. If the real rate of interest is three percent before tax and two percent after tax, the nominal rate on the debt would rise to nine percent (as opposed to seven percent if there were indexing).[9] The after-tax real rate of return to the creditor would still be two percent [9(1 - 0.33) - 4], as would the cost to the borrower. Failure to index generates neither tax savings nor tax costs and thus has no effect on investment decisions.

This passage appears to assert that indexing interest for inflation will reduce interest rates by the inflation rate divided by one minus the effective tax rate. As a theoretical matter, that seems correct to me. The next question is whether the effective tax rate will be the high rate paid by taxpaying individuals and taxpaying corporations (33 percent in the example given) or a lower rate closer to the weighted average tax rate on all interest receipts from

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[8] McClure and Zodrow, *Treasury I and the Tax Reform Act of 1986: The Economics and Politics of Tax Reform*, 1 *Econ. Perspectives* 37 (1987).

[9] The interest rate increases by anticipated inflation divided by the after-tax rate of return. Here this is four percent divided by (1 - 0.33) = six percent.

U.S. borrowers. Since the higher taxed lenders are more likely to be the marginal lenders, my guess is that this higher rate will determine the outcome.

Whichever turns out to be the case, there seems to me to be a significant possibility that adoption of the proposal would contribute to solving the Federal government's budget problem, by reducing the interest which the United States government has to pay on its outstanding debt. Moreover, any such reduction in rates could be a significant stimulus to the economy, by reducing the effective cost of borrowing for personal needs where tax deductions are not allowed. In the case of families building homes and businesses borrowing for business expansion, any reduction in rates would partially offset the increase in effective rates resulting from the reduction in the tax deduction.

In an era when a declining dollar and a low growth rate has made the United States only a significant and no longer the dominating economic force in the world, it is necessary to examine the international competitive effects of any major tax proposal. Some have shrugged off indexing of debt as impractical because of its alleged adverse effect on U.S. borrowers in competition with foreign borrowers. Is that concern sound?

The argument appears to be that under a U.S. tax regime limiting business interest deductions as I propose, a Japanese or German bidder for a company or a property in the United States will be entitled under its tax law to deduct both the inflationary and the noninflationary elements of interest. Therefore, such bidders will be able for the same after-tax cost to borrow a larger sum than their U.S. competitors, whose tax deduction will under my proposal be limited to the noninflationary portion of the interest payments.

To consider the difference between U.S. effective borrowing costs and foreign effective borrowing costs attributable to my proposal as controlling is to confuse the minor with the major. Interest rate differences between countries are substantial. For instance, on a recent date the prime rate in this country was 8.84 percent; in Japan it was 4.91 percent; in Germany it was 8.06 percent. So are tax rate differentials. In Japan, the corporate income tax rate is being reduced to 37.5 percent; in Germany, it apparently will remain over 50 percent. The gross after-tax cost to a borrower of eliminating the inflation subsidy at a four-percent inflation rate is only about 1-1/3-percent, and that effect will be reduced by any reduction in interest rates which occurs. This effect must be considered minor in comparison with the differences which exist among international effective borrowing costs due to other causes. It can be noted also that most European borrowers seeking properties in the United States do their borrowing here, so that the dollar earnings of the properties can pay off the debt without currency valuation risks.

In sum, taking the tax subsidy out of interest in the United States will not be painless. Additional calculations will be necessary in many tax returns. It will be necessary to cope with the complexity of rentals. Information reporting will become more expensive. In some instances, the competitive position of U.S. and foreign bidders for U.S. properties will be altered marginally in favor of the foreign bidders. The universal longing for stability in the tax law will one more time be disappointed.

Nevertheless, these costs seem minor in relation to the gains to be achieved by eliminating the interest subsidy. The subsidy is large: one-percent of principal, nearly 10-percent of prime rate, a present value of 10 percent or more of principal amount, even at today's moderate inflation rates. If we are trying to reduce our indebtedness, why does our government substantially subsidize borrowing? If we worry because corporate debt has risen from $1 trillion in 1980 to $1.8 trillion in 1988, and continues to climb, why do we encourage still more corporate debt? If we are uncertain whether the unprecedented flood of corporate recapitalizations and LBOs is in our national interest, why do we load the deck by Federal subsidy of the borrowings which fuel those transactions? If we have gone so far as to deny an interest deduction for personal expenditures, why should we not also deny a deduction (and correspondingly grant an exclusion from income) for the portion of "interest" which is only an offset for the inflationary change in value of the principal, and is not an expense at all?[3]

It is time we faced up to the Federal subsidy inherent in all interest transactions and eliminated it.

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[3] See *Lomax v. Peter Dixon & Co., Ltd.*, 2 All Eng. Law Rep. Ann. 256 (U.K. Court of Appeal 1943) for the principle that, if commercial adequate interest is paid, an additional amount intended to adjust principal for inflation is taxed as capital, not interest.

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Mr. DORGAN. Mr. Calkins, thank you very much. Let me ask you a quick question, Mr. Calkins.

You say there is an irresistible pressure to move towards debt financing, an irresistible pressure occurring now, and that is what results in this state of LBO's and increasing debt financing.

Why would there be an irresistible pressure now when in fact the pressure should be diminishing since we reduced the corporate rate. Reducing the corporate rate makes that interest deduction less valuable. So while the pressure is diminishing, why is the number of LBO's increasing?

Mr. CALKINS. That's a very good question, but there are some reasonable explanations.

The first one is it takes quite a long time for the financial markets to learn things. And there has been a learning of the fact that it is prudent for a pension fund to buy high yield bonds if you buy enough of them from enough different issuers.

Secondly, we have made other changes in the tax structure which make a substantial difference. For the first time in history, we have a corporate rate which is higher than the individual rate. And therefore everybody is looking, everybody, everybody in business and fussing with corporations, is looking critically at the corporate rate that they are paying for the first time in history higher than the individual rate, and saying how can we get out from under that?

We also have repealed *General Utilities,* which was a method of facilitating exit from corporate structures.

So, with all of that attention focused on it, the obvious answer that occurs to most financial officers is let's restructure with debt rather than with equity, and it is now an acceptable thing to do.

Let me mention one more. Another major factor is that making an unfriendly tender offer has become a respectable thing to do.

Even as recently as 5 years or so ago, it was not a respectable thing to do. Boone Pickens did it, and various other people who charge out ahead did it. But the sort of major corporation with the normal board of directors did not do it.

Mr. DORGAN. I might mention it is not respectable in every parlor.

Let me ask you why, again knowing what you just said to me—why still wouldn't there have been 10 or 15 years ago enormous pressure for nonhostile conversions to debt in acquisitions because the corporate rate was higher, there would have been more pressure, the interest deduction was more valuable then I would guess? And so I still don't quite understand given your answer.

Well, proceed, if you will.

Mr. CALKINS. I was a participant in many leveraged buyouts during the fifties and sixties. They related to family-sized companies in the Middle West and not to major companies listed on the New York Stock Exchange.

I think the reason that the larger companies didn't do it is because having a ratio in which the debt was not more than 40 percent of your total capital was quite universally considered to be a good business practice among financial officers, bankers, and boards of directors.

The idea that that was not a necessary way of carrying out business didn't occur to people until this decade. The attention that was focused on tax shelters was one of the factors that caused people to recognize the importance of leverage.

I think it is largely a learning curve. The pressure really was there, but people were willing to operate without that much debt because that was considered to be good corporate practice. It was prudent to protect you from a downturn and, more than that, it was the way in which a company had the assets on hand in which they could back new ventures, new products, new acquisitions when they wanted to.

Mr. **Dorgan**. You're saying that there was a more conservative practice in the past.

Mr. **Calkins**. Yes.

Mr. **Dorgan**. And a willingness to exhibit more risk, and accept more risks today?

Mr. **Calkins**. And if you didn't do it, there wasn't any penalty. That is, there weren't the acquisition people around to in effect say if you don't recapitalize yourself, we will recapitalize you. In the absence of that acquisition force, many, many businesses simply said we can run our business better, do more for our shareholders if we have only a prudent amount of debt and not an excessive amount of debt.

Mr. **Dorgan**. Thank you.

Mr. Bernstein, one quick question. Your testimony comes to us from a practitioner and someone who is involved in the business.

Do you, however, in doing your day-to-day work come across instances in which you wonder whether broader public policy shouldn't circumvent what is trying to be done? Or do you generally think that most of the activity in LBO's is healthful, productive and useful?

Mr. **Bernstein**. Well, I think that, by and large, the stepped-up activity in acquisitions has been helpful and useful. I think that the American concept of leveraging corporations is a not incorrect concept. We for years have leveraged real estate and leveraged other types of investments. The Japanese have proved that leveraging corporations can be a highly effective thing to do.

I think what we are seeing is a financial world that says that this is an appropriate way to finance business.

I also think, as I said before, that we are seeing investors being substantially disillusioned with common stock and wanting some sort of a guaranteed return, or at least a likely return on their investment.

Mr. **Dorgan**. I might observe that in Japan the higher risk that travels with higher debt is a little different in the sense that the Government is a partner and guarantor in many respects with some of those corporations.

I might also observe that, as Boone Pickens has discovered recently, this hostile takeover activity is not viewed with great love in Japan, and there are almost no hostile takeovers occurring in Japan.

So, if one were to compare what we are doing with the Japanese, one might observe that the speculations with hostile takeovers here is speculation they don't allow, and presumably because they don't think it's good as a matter of public policy for their economy and for their country.

Mr. **Bernstein**. I think you're talking about a cultural difference. I would not be surprised if you see within the next 10 years the Japanese going toward the acquisition techniques that we use in this country. They have followed us in a lot of our financial techniques.

Mr. **Dorgan**. I think it is partly cultural. I think you're correct about that. But I think it is driven also by substantial economic reasons.

I think they understand what primer books ought to tell us, and that is you load something up with debt and throw them into play and hostile circumstances, you don't have time to do the kind of business you ought to do, and that is make better products and sell at better prices.

But the committee certainly does appreciate your contribution. Coming from a practitioner, it's a useful perspective, and we appreciate, Mr. Bernstein and Mr. Calkins, your testimony today.

Mr. **Bernstein**. Thank you.

Mr. **Calkins**. Thank you.

Mr. **Dorgan**. The Chair next will call on the panel with Mr. James Poterba, professor of economics, MIT; Mr. Brian Wruble, Equity Capital Management Corp.; and Mr. Roger Mentz, representing Clayton & Dubilier, and Mr. Mentz is accompanied by Joseph Rice who is president of Clayton & Dubilier, Inc.

Mr. **Coyne** [presiding]. I would like to just to point out at the beginning that Dr. Altman was unable to be with us today, and I ask unanimous consent to have his entire statement included in the record.

Mr. Poterba.

Oh, it's Mr. Poterba who is not here?

OK. Mr. Wruble can begin.

STATEMENT OF BRIAN F. WRUBLE, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, EQUITABLE CAPITAL MANAGEMENT CORP., NEW YORK, NY

Mr. **Wruble**. Thank you.

My name is Brian Wruble. I am president of Equitable Capital Management Corp., which is a subsidiary of Equitable Life in New York.

Equitable Capital is one of the largest private lenders in leveraged buyouts. The names of most of the companies whose leveraged buyouts we have financed would not be familiar. They tend to be smaller businesses. Often they are companies that are sold by conglomerates to their managers or by retiring founders to the next generation of managers. That kind of LBO, we think, the small, private, nonhostile, nonbust-up deal, is the mainstream of this business. The "mega-deals" get all the press attention, but the real all-American deal involves the essence of the American dream: managers buying the businesses they have been running their entire business lives from a large and bureaucratic corporate owner, or from an individual owner-manager who is retiring, or from anonymous and uninvolved public shareholders.

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We have examined carefully all of the options the committee has been considering, and we urge you to make no changes in the Tax Code to deal with LBO's. We believe tax policy is a very blunt instrument with which to correct something that most people cannot agree is a problem, and that many, including ourselves, will argue is very beneficial. Tax changes in this area are akin to giving the strongest known "wonder drug" to a patient whom we cannot agree is sick. The drug may not kill him, but we can be pretty sure it will have some harmful side effect that we cannot predict. One side effect in this case is likely. Any changes which punish the use of debt will favor the older, slower growing, more established companies. Use of debt is associated with younger, more energetic, more fiercely upstart companies in the same way it is associated with young people trying to own their first homes.

Do we really want to tilt the field to help AT&T beat up on Sprint? I would like to address three policy questions at this time. First, do leveraged buyouts cause unemployment? In the 1950's, the word "automation" caused great economic debate. Would computers throw millions of workers out of their jobs? A shortsighted analysis could easily have led to that conclusion. If a machine is purchased by an auto manufacturer to do a job that a man had done previously, and if that man is then laid off, have we not increased unemployment? Yes, but only in the short run and only in a specific plant. In the long run, that company was able to remain more competitive than it otherwise would have been, increasing employment.

Leveraged buyouts are no different. If they promote efficiency, they promote higher employment in the long run. And they do promote efficiency.

The typical CEO of a publicly traded corporation might own one-tenth of 1 percent of his company's stock. If he wastes $1 million, it costs him personally $1,000. In an LBO, the same CEO might own about 10 percent of his company. A million dollars of waste costs him $100,000. Attention to the details that promote efficiency becomes almost a religion to the CEO in this example.

Second, is American industry becoming dangerously burdened with debt? We don't think so. Obviously, adding debt to any company's balance sheet increases the financial risk of the company. However, the total risk in any company is a combination of its financial risk and its business risk. If we can make the company more competitive, we reduce its business risk considerably.

LBO investors are fanatic about reducing their risk. The companies they select are nearly always those with the least volatile businesses. Therefore, the quality of the buyers of much of this new debt is much higher than average. Their businesses are fundamentally more stable, making them better able to withstand recession.

Third, is the taxpayer subsidizing leveraged buyout activity? We believe elimination of the tax deduction for interest on acquisition debt will not raise revenues. Instead, it will severely dampen the activity. Fewer deals will take place, and those that do take place will happen at much lower prices, perhaps with the Dow Jones Industrial Average at 1,000.

We believe that a proper long run dynamic analysis will show that leveraged buyout activity is revenue positive from the vantage point of the U.S. Treasury.

Someone made the case that LBO debt is really equity and should be treated for tax purposes as if it were equity because it carries equity-like risks. However, it is not risk that determines whether something is equity or debt. We believe it has to do with ownership and reward.

As debt holders, we have none of the privileges of ownership. We do not vote and we do not share in the upside.

Tax deductibility affects the ability to use debt, and like it or not, debt is a critical ingredient in a healthy growing economy. "Banana Republic" countries which do not have functional credit markets have very poor performing economies.

In concluding, I am not here to say that the business of doing leveraged buyouts is without flaws. It has its abuses. We are, for example, in favor of regulations to promote the fullest possible disclosure so shareholders have the information and the time to decide whether to sell their stock.

We believe that corporate directors should be held accountable for acting in the best interests of shareholders. We believe the antitrust laws should be reasonably and fairly enforced.

However, on balance, we believe that an enormously beneficial process is going on here. We urge Congress to forgo the use of a wonder drug to cure this nonexistent illness.

I thank you for this opportunity to address the committee. I am always available to speak with you further on this subject.

[The statement of Mr. Wruble follows:]

BRIAN F. WRUBLE
TESTIMONY ON LEVERAGED BUYOUTS
WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
MAY 16, 1989

My name is Brian Wruble. I am President of Equitable Capital Management Corporation in New York City. Equitable Capital is a subsidiary of Equitable Life, the third largest life insurer in the United States.

Equitable Capital is one of the largest private investors in leveraged buyouts. Our normal role is as a lender. We provide subordinated loans. The names of most of the companies whose leveraged buyouts we have financed would not be familiar to the average person. They tend to be smaller businesses. They are often companies sold by conglomerates to their managers or by retiring founding entrepreneurs to the next generation of managers. That kind of LBO, the small, private, non-hostile, non-"bust-up" deal is the mainstream of this business. The "mega-deals" get all the press attention, but the real All American deal involves the essence of the American Dream --- managers buying the businesses they have been running their entire business lives from a large and bureaucratic corporate owner, from an individual owner/manager who is retiring, or from anonymous and uninvolved public shareholders.

We have examined carefully all of the options the Committee has been considering. We urge you to do nothing in the area of tax policy. We believe tax policy is a very blunt instrument with which to correct something that most people cannot agree is a problem and that many, including ourselves, will argue is beneficial. Tax changes in this area are akin to giving the strongest known "wonder drug" to a patient whom we cannot agree is sick. The drug may not kill him, but we can be pretty sure it will have some harmful side-effect that we cannot predict. One side-effect is likely: Use of debt is associated with younger, more energetic, more fiercely competitive "upstart" companies in the same way it is associated with young people trying to own their first homes. Any changes which punish the use of debt will favor the older, slower more established companies. I doubt that legislation can be crafted which will not have ripple effects outside of the acquisition arena. Do we really want to tilt the field to help ATT beat up on Sprint?

From what I hear and read, there are several issues surrounding the leveraged buyout phenomenon that are troubling to our government.

- Do leveraged buyouts cause unemployment?
- Is American business becoming overburdened with debt?
- Is the use of debt being unfairly "subsidized" by the U.S. taxpayer?

1. Do leveraged buyouts cause unemployment?

In the 1950s, the word "automation" caused great economic debate. Would computers throw millions of workers out of their jobs? A shortsighted analysis can easily lead to that conclusion. If a machine is purchased by an auto manufacturer to do a job that a man had done previously, and if that man is then laid off, have we not increased unemployment? Yes, but only in the short run and only at a specific plant. In the long run, that company was able to remain more competitive than it would otherwise have been, retaining more jobs, and even increasing employment. At the same time, the makers of computers were able to grow rapidly, becoming themselves major providers of jobs and the core of an industry in which we have held the international lead for many years.

Leveraged buyouts are no different. If they promote efficiency, they promote higher employment in the long run. And they do promote efficiency, if for no other reason than good old-fashioned American incentive. The typical CEO of a publicly traded corporation might own one-tenth of one percent of his company's stock. If he wastes $1 million, it costs him, personally, $1000. In an LBO, the same CEO would own about 10% of his company. $1 million of waste costs him $100,000. That is a horse of a different color. Attention to the details that promote efficiency becomes almost a religion to the CEO in this example.

2. Is American Industry Becoming Dangerously Burdened with Debt?

We don't think so. Obviously, adding debt to any company's balance sheet increases the financial risk of the company. However, the total risk in any company is a combination of its financial risk and its business risk. If we can make the company more competitive, we reduce its business risk considerably. LBO investors are fanatic about reducing their risk. The companies they select are nearly always those with the least volatile businesses. Therefore, the quality of the borrowers of much of this new debt is much higher than average. Their businesses are fundamentally more stable making them better able to withstand recession.

Let me make one more point here. One obvious result of the leveraged buyout activity of recent years is a much higher level of the stock market than otherwise would have been the case. Those who decry the so-called "de-equitization" of the economy miss the point that companies who choose to issue new equity today can do so at much higher prices than would otherwise have been possible. Moreover, the higher stock market has raised the value of corporate and public pension plans, lowering the cost of funding future retirement, increasing corporate profits and reducing the budget outlays of states and municipalities. It has increased the wealth of millions of American stockholders, enabling them to continue to support the longest economic expansion in peacetime history.

Stock market speculators may increase volatility of the market. They often sell when prices are low and buy when prices are high. In contrast, the LBO buyer is the purest of value buyers, buying low and selling high. Operating in this way, the LBO buyer helps reduce the volatility of our stock market. This lowers the cost of capital for all American industry, once again benefitting our international competitive position.

That brings me to the final issue:

3. Is the taxpayer subsidizing leveraged buyout activity?

The purpose of debt in a leveraged buyout is not capturing the tax advantage, although it does make the transactions more attractive. The purpose of leverage is to bring ownership within the financial reach of those who can make the company operate more efficiently, and at the same time to create a wide disparity between the reward for success and the penalty for failure. This is not a business of financial gymnastics. It is a business of people. It is "Capitalism 101". Fantastic things happen when you give a management team a once-in-a-lifetime chance to become very wealthy or to lose everything, including their careers. But very few management teams can accumulate enough capital to own, as a typical example, 20% of a $100 million company. If banks and insurance companies will agree to lend most of the purchase price, a stake in the business that is truly meaningful becomes financially within the grasp of the management team.

At its roots, this concept is no different from what takes place when a young couple borrows most of the money --- a first mortgage from their bank, a second mortgage from a credit company and half the downpayment from their parents --- to buy their first home. For many people this becomes the route to the accumulation of most of the capital they will have when they retire. If much of the interest were not tax-deductible, many of the homes would neither be bought nor built.

I am convinced of one thing: Elimination of tax deductibility of interest on acquisition debt will not raise revenues. Instead, it will severely dampen the activity. Fewer deals will take place. Those that do will happen at much lower prices. Those prices might be found with the Dow Jones Industrial Average at 1000. We believe that a proper long-run dynamic analysis will show that leveraged buyout activity is "revenue positive" from the vantage point of the U.S. Treasury.

Some have made the case that LBO debt is really equity and should be treated for tax purposes as if it were equity because it carries equity-like risks. Does this argument make payments on office building mortgages in Houston nondeductible? It is not risk that determines whether something is equity or debt. We believe it has to do with ownership and reward.

As debtholders, we have none of the privileges of ownership. We do not vote, and we do not share in the upside. If a company hires a worker to do a job, it pays the agreed upon wage no matter how successful the company becomes. The wage is a deductible cost of doing business. The same holds for materials used in the manufacture of a product. High profits in the business do not obligate the manufacturer to pay more for his materials. So too with the rent on a corporation's headquarters building. Money is just another factor to be rented. If the leveraged buyout is successful, the company is not obligated to pay us any more than our bonds allow for. They have rented our money. We expect them to pay for it. If they succeed, as owners, they get the excess. If the company fails, we will insist that the owners feel the first pain.

Tax deductibility affects the ability to use debt, and like it or not, debt is a critical ingredient in a healthy growing economy. "Banana Republic" countries which do not have functional credit markets have very poor performing economies.

I am not here to say that the business of doing leveraged buyouts is without flaws. It has its abuses. We are, for example, in favor of regulation to promote the fullest possible disclosure so that shareholders have the information and the time to decide whether to sell their stock. We believe that corporate directors should be held accountable for acting in the best interests of shareholders. We believe the antitrust laws should be reasonably and fairly enforced.

However, on balance, we believe that an enormously beneficial process is going on. We urge Congress to do nothing which might throw this particular baby out with the bath water.

I thank you for this opportunity to address the Committee. I am always available to speak with you further on this subject.

BRIAN F. WRUBLE
WRITTEN STATEMENT ON LEVERAGED BUYOUTS
WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
MAY 16, 1989

These remarks specifically address many of the issues set forth in Press Release #13, distributed on April 12, 1989. The comments below are not intended to comment on each proposal set forth but, rather, speak to areas where Equitable Capital Management Corporation and its professionals have extensive experience.

In the interest of readability, these remarks have been ordered to match the numbered proposals in the original U.S. House of Representatives document.

B. Options Modifying the Current Tax Treatment of Corporate Interest

1. This proposal provides for the denial of interest deductions on debt incurred in making a hostile acquisition of stock or the purchase of assets of the corporation subsequent to a hostile tender offer. A hostile tender offer would be defined as one disapproved by a majority of the independent members of the board of directors of the target corporation.

   Although Equitable Capital does not participate in hostile acquisitions, the fact that a transaction may be labeled "hostile" does not justify a differential treatment under the tax code. If this provision were to be enacted, thereby effectively abolishing hostile takeovers, the direct effect could very well be the entrenchment of management and a significant reduction in the efficiency of the capital markets.

   As we understand it, this provision would cause the tax law to allow existing management to exact a higher price for the company from hostile acquirers in order to have that hostile acquirers bid accepted as a friendly acquisition. This form of corporate blackmail may very well encourage dealings to take place which are not above board and, in fact, may result in unreasonable compensation from the hostile acquirer in order to back down and accept the deal as a friendly one.

   We think this would cause great opportunity for much mischief to take place in a negotiation of a purchase price of a company subject to a hostile tender offer.

2. This proposal would deny the deduction of interest for debt incurred to finance mergers which are not found to be "in the public interest".

   The provision suggests that any merger which would be expected to reduce employment by more then one hundred employees at a location would require approval by the Federal Trade Commission. The FTC would determine the extent of losses on the tax base to a local government or geographic area. Upon finding that a substantial adverse effect would occur, the FTC may rule that the transaction is not in the public interest and interest deductibility would be denied for the debt incurred to finance the merger.

   We do not believe it is appropriate for the FTC to be empowered to make judgements on the likelihood of a loss of jobs, or to determine if a transaction is not in the public interest due to a prospective judgment that a loss of jobs is likely to occur. This provision is far more subjective than the FTC's normal powers, in which it may find that a merger would have anti-competitive effects under the anti-trust law. In short, it grants excessive powers to one governmental agency.

3. This motion advocates the exclusion of or reduction in the deductibility of interest on high yield debt or junk bonds. As defined, a "junk bond" would possess one or more of several characteristics such as: a high interest rate as based upon the prime rate, or percentage points above the applicable federal rate; an obligation with significant subordination provisions; or convertible security having non-investment grade bond ratings. The deduction for interest payments would be denied under this provision for any debt issued, on an aggregate basis, in excess of a certain dollar limit, such as $50MM.

   This provision would restrict larger transactions from happening, while allowing small LBOs to take place. While this might allow the majority of all LBOs to take place, it would effectively eliminate the use of acquisitions as a means to enforce greater market and operating efficiency upon the larger corporations of America — those very corporations who may benefit most from a restructuring, due to the inefficient way they have been run. We know of no reason why a buyout of $51MM is any more or less proper than a buyout of $49MM and therefore believe the limitation amount is a totally arbitrary one.

4. This recommendation would provide for the non-deductibility of a percentage of any corporate interest incurred, including debt that may serve as expansionary capital. This provision suggests that the amount of interest which is disallowed may raise a specified amount of revenue used to offset the double taxation of dividends. Clearly, the intent here is for a balancing of the "playing field" in corporate capital structures.

   The incurrence of debt would be made less attractive and the payment of dividends more attractive, by means of the tax code.

   Although we agree in principle with this proposal, it is difficult to envision a practical application. It is unpredictable as to where the dollars of revenue gain and revenue loss would come from and the concept of revenue neutrality on such a broad provision is probably an illusory one. At the very least, any such provision would need to be phased in and provide "grandfathering" to avoid seriously damaging existing corporate structures.

   Enactment of such a proposal will require a clear definition as to what are dividends and what constitutes interest. To date, the Treasury Department has been unable to develop a clear definition of debt and equity. It may be equally difficult to determine what is interest and what is a dividend.

   Improving the treatment of equity capital in the tax code is advisable. The methodology by which this is done has tremendous opportunity for trouble making. The implications are far-reaching and will require a very gradual phasing in over an extended period of time.

5. This plan calls for the elimination of the deduction of corporate interest expense, replacing it instead with a credit to shareholders representing the corporate taxes paid on earnings distributed as dividends.

   The approach here is to direct corporations to incur less debt and instead to pay out dividends to shareholders, encouraging the raising of equity capital. As we see it, this provision will require a terribly complex system of tax reporting that includes, not only a 1099 form to be issued to every individual shareholder who receives a dividend, but also a K1 tax report for every shareholder. This would be an incredibly burdensome task forced upon every public corporation in America.

   Upon completion of an IRS audit of a corporation's tax return many years in the future, any change in the tax liability of that corporation, retrospectively, will require an amended 1099 and K1 report to be issued to every shareholder. Every shareholder, after their corporation has had its tax bill revised by the IRS, would have to file an amended 1040 tax return for that year. This is, at best, a prudent approach to the tax code. Furthermore, the cost of such a system would be staggering.

6. This recommendation provides for denial of the deduction of interest in excess of a specified amount, rather than putting a dollar limitation on debt for which interest could be deducted, or any dollar limitation on the gross dollars of interest to be deducted. In short, to the extent that interest rates exceed a certain amount, they are deemed objectionable and denied for deductibility purposes.

   This provision flies in the face of the free market risk and reward trade-off mechanism, in which buyers of debt are provided higher rates of return for incurring greater risk. It legislates the availability of credit: borrowers witn higher risk, no matter how worthy, would have a hard time raising debt. This would hinder young growing corporations from being able to borrow money to expand their business. We believe that legislating interest rates is a dangerous proposition at best.

7. A normative level of debt to equity for a corporation would be established, with 80 percent suggested here. Any transaction which results in debt/equity levels above that percentage will be penalized with a reduction in interest deductibility on debt incurred. We don't believe it is appropriate to legislate a normal debt to equity ratio for any corporation, since the appropriate ratio varies by industry, economic time and by the point in the life cycle of any corporation's development. Arbitrarily setting the ratio for "normal debt to equity" will cause severe dislocations in the economy and allocations of capital which inhibit market efficiency.

C. Options Modifying The Current Tax Treatment of Equity Distributions Made by Corporations

Equitable Capital advocates the elimination of double taxation of income at the corporate level and then again upon the payment of dividends to shareholders. In leveling the "playing field", we suggest eliminating the double taxation of corporate income then disallowing interest deductions. We recognize that any tax relief on the payment of dividends has serious revenue implications and would need to be offset by some other revenue raising proposal.

1. This is similar in some ways to an option previously discussed, in that it provides for a shareholder level credit equal to the amount of tax paid paid by the corporation. For example, if 40% of the dividends paid by the corporation does not exceed the amount of taxes paid by the corporation, then the shareholders would get to deduct those corporate taxes against their dividend income.

Once again, this provision results in a severe reporting problem. While it is laudable that there be an offset against double taxation of dividends, the reporting problems here would be excessively budensome. Upon audit of a corporate tax return, these dividends might have to be adjusted many years later, causing a restating of every shareholder's tax liability and requiring every shareholder who received a dividend to file an amended tax return.

2. This option recommends the exclusion of a percentage of dividend income received by individuals. In the past, the tax law providedfor a dollar exclusion of dividend income received by individuals. This provision excludes a percentage of dividend income received from taxable income for calculating tax liabilities.

This type of provision is a positive one. We could support this type of provision or an absolute dollar amount exclusion, similar to previous tax codes. Obviously, this type of provision would need to be tied into the progressivity of the personal income tax. This option is administratively the most workable alternative.

3. In theory, this proposal works like option #2, except that the offset against shareholder income will be provided for at the corporate level. A corporation would be allowed to deduct a percentage of the dividends it pays out to shareholders, allowing for the restructuring of a corporation's balance sheet without the incurrence of debt. This enables corporations to pay out excess cash in the form of dividends, while obtaining a tax benefit. The loss of tax revenue resulting from this provision might be very substantial. It remains to be seen how practicably it can be implemented without seriously impacting the federal deficit.

A further provision in proposal C-3 would change the option with regard to dividends paid to foreign or tax exempt shareholders. We find it objectionable that a corporation's tax status should be impacted by the actions of a non-governmental third party. Under this option, a corporation's tax would be impacted by the sale of stock by a taxable entity to a foreign holder or a tax-exempt holder. It is improper that the corporation should be impacted by the tax status or nationality of a public shareholder.

D. Provides For Options Relating To Investment Banking Fees

Generally speaking, these provisions focus on mergers and acquisitions activities, calling for a variety of excise taxes on fees received transactions.

1. This suggestion recommends a non-deductible excise tax be imposed on compensation or any income derived by any party participating in an LBO. An additional 20% excise tax on management fees earned in transactions, is proposed, resulting in 25% excise tax on fees earned by LBO sponsors.

We find singling out one type of financial activity as subject to excise taxes, when all others are not, to be inappropriate. No one activity should be more or less worthy of taxation than any other. These fees are already fully taxable at full income tax rates to the recipient.

2. The option suggests an excise tax, perhaps as high as 50%, on "excessive" compensation derived by an individual providing services in an LBO activity. For example, $50MM a year might serve as a threshold above which excessive compensation is to be calculated. There is no differential here between a one man shop earning $50MM and an investment bank with two thousand employees earning $50MM. There is no provision in the tax code that provides for excise taxes on fees charged by medical doctors, attorneys or any other professional or business corporation. We think it is unsuitable to single out mergers and acquisitions for generating excessive fees, upon which very large excise taxes should be exacted.

3. This statute would provide for a nondeductible excise tax to be assessed on two-tier advisory fees, based upon the success of an offer. We agree, conceptually, that two-tier advisory fees should be reviewed. These activities could be regulated by the SEC or the NASD. We believe it is correct to prevent the activity from occurring then allowing it to occur with a type of" sin tax" collected because it has occurred. We believe its inefficient to use the tax code to effect this type of regulatory change.

E. Options Relating To The Tax Treatment Of Foreign Persons And To Issues Of Foreign Investment

In general, the point of these provisions is to attempt to level the "playing field" between foreign investors and domestic investors in LBOs. These provisions would attempt to reach foreign equity owners of U.S. LBO companies and foreign holders of securities issued by companies that have experienced an LBO.

While we support the leveling of the "playing field" between domestic and foreign acquirers by reviewing our tax policy, we should note that as long as foreign tax codes treat American companies as equals, we should not unilaterally change our tax code provisions. U.S. companies operating overseas generally receive the same tax advantages as companies in their own home market. For example, if an LBO is conducted with a U.K.-based company, a U.S. firm may take advantage of provisions in that country's tax code. To undertake differential provisions in our own country's tax code will expose US companies to retaliation.

In summary, many of these recommended changes would severely impact governmental and international business goodwill.

2. This provision would provide the reimposition of a 30% witholding tax on portfolio interest on U.S. debt holdings earned by foreign persons.

   This provision, would discourage any foreign investor from making portfolio investments in the US. Such a move would materially cut off the flow of foreign funds into the United States, worsening our balance of payments. As this isolation from the world market occurs, turmoil in the U.S. debt market could evolve. Provisions such as this would result in serious negative implications for both the liquidity of U.S. debt markets and the availability of funds.

F. Options Which Would Modify The Tax Consequences Related To Certain Corporate Financing Transactions.

1. This provision would apply a confiscatory excise tax upon the value of assets acquired pursuant to certain stock or asset acquisitions. For example, it provides that in the case of a hostile takeover, or more broadly perhaps any LBO, where 50% or more of the stock or assets of a corporation are acquired, that a nondeductible excise tax will be imposed on the company's assets.
   The rates suggested have been in the range of 3-5%, depending upon the revenue considerations being made. The revenue raised by such a provision would be invested in a venture capital/small business revolving fund used to support the growth of small businesses in America. The provision suggests that an exemption might be provided for transactions under a threshold amount such as $50MM or so.

   It appears to us that all this provision will do is reduce corporate values. An excise tax would slow acquisition activity and eliminate the beneficial effects of leveraged buyouts.

2. A concept that calls for a 50% exclusion from taxes for gains realized on the sale on an asset financed with either corporate equity or individual savings and held for a minimum of three years. As such, this provides for a substantial reduction in capital gains tax on very long-term capital gains. This provision would make acquisitions much more attractive for any entity or individual which does not have to incur debt to make its acquisition.

   As a result, this unbalances the "playing field" to the advantage of cash- rich corporate acquirers. The "haves" would be given a leg up on the entrepreneur who needs to borrow part of his capital to make an acquisition. This would favor the concentration of capital to detriment of the entrepreneur.

   While the intent of the provision is to encourage long-term investment and savings, it goes about achieving those two objectives in an unworkable fashion, in which the cure causes far greater harm than the problem originally perceived.

G. Proposes Three Options Related to Employee Stock Ownership Plans

Equitable Capital does not participate in this market, and therefore feels it is inappropriate to offer specific commentary.

H. Miscellaneous

The recommendations set forth deal directly with regulatory and statutory provisions concerning mergers and acquisitions. This is the area of the provisions that we are most receptive to.

We strongly support stringent, and tougher, regulation — not taxation — to deal with the perceived problems resulting from leveraged transactions. For example, we wholeheartedly favor prudent regulation that promotes full disclosure, so that shareholders have the information and time needed to decide whether to sell their stock. Corporate directors should be held accountable for acting in the best interests of shareholders. And, we believe the antitrust laws should be reasonably and fairly enforced. We are concerned about the practice of paying fees, which vary with transaction success, to firms to provide "fairness" opinions.

It is sufficient that the SEC has power to enforce regulations without providing for confiscatory excise taxes and other such tax penalties for violations of said regulations. We believe use of the tax code is not the proper venue in which to accomplish these changes and is too blunt an instrument to use to affect desired regulatory changes.

Mr. COYNE. Thank you, Mr. Wruble.

Mr. Mentz.

STATEMENTS OF J. ROGER MENTZ, ON BEHALF OF CLAYTON & DUBILIER, INC., AND JOSEPH L. RICE III, PRESIDENT, CLAYTON & DUBILIER, INC.

Mr. MENTZ. Thank you, Mr. Chairman. Good afternoon.

It is a pleasure to appear before this committee once again on behalf of Clayton & Dubilier. Accompanying me is Mr. Rice, the president of Clayton & Dubilier, who has a separate statement. As you may recall, we testified previously in March on the tax policy aspects of mergers and acquisitions.

In our prior testimony, we sought to provide a conceptual framework for analyzing the various legislative proposals to alter the tax treatment of corporate finance transactions. In this testimony, we have analyzed the options set forth in the press release. I will provide the tax policy analysis. Mr. Rice will discuss the practical business implications.

My testimony is long. If you simply go through the bold-faced captions, I think you will understand the points that are being made.

I move to page 5—general comments on the options. Enactment of any of the proposals contained in the press release would affect the value of all American corporate businesses.

For example, if a fixed percentage of interest payments were nondeductible, transactions for the purchase and sale of businesses would continue, but the prices would be dramatically reduced. Thus, a substantial change in the tax law will affect existing values of corporations. This is true even with liberal transition rules. Indeed, fundamental changes in the tax law of any kind always have a retroactive effect, even if enacted with generous effective dates and transition rules.

I will now move to page 15 of my testimony—the integration proposals. The press release contains three suggestions for integrating the corporate and shareholder tax systems. Many of our major trading partners have achieved integration. One critical point should be noted: Not one of those integration systems is financed through the disallowance of interest deductions. Indeed, there is no more logic to denying interest deductions to finance corporate-shareholder integration than denying deductions for salaries, rents, and so forth. Thus, while integration may be desirable, we believe it is not desirable if paid for through the disallowance of interest deductions.

Despite best intentions, we further question whether in today's world of Gramm-Rudman budget pressures, corporate-shareholder integration could be achieved. Treasury made the same point in its earlier testimony. Any such proposal could be bifurcated in the subsequent legislative process, with the result that the integration proposal is discarded, and the revenue raiser is included and spent for other purposes.

I would like to move now to options relating to the tax treatment of foreign persons and to issues of foreign investment. The options described in part E apparently are limited to counteract the bias that would be created through a limitation on interest deductibility in favor of foreign acquirers that could get a deduction in the foreign jurisdiction.

All of the proposals in this section have serious policy and technical problems. We do not believe that the problem of foreign competition that would be created through the enactment of a significant interest restriction is soluble.

The proposal that will impose an additional tax on a U.S. corporation acquired by a foreign person to account for interest incurred outside the United States is the principal proposal.

For example, under this proposal, if British Petroleum were to acquire a corporation in the United States, an allocation would be made of all of BP's worldwide interest expense and a determination made as to how much of that expense should be allocated to the U.S. acquisition. This analysis would occur even though BP is not a U.S. corporation and is not engaged in U.S. business. The allocable amount of BP's interest would be included as income to the U.S. corporate subsidiary of BP.

Obviously, the IRS would be unlikely to convince BP to submit to a worldwide audit. However, if BP failed to properly account for its worldwide interest payments, there would be a mandatory income inclusion. Such an approach would be insulting to the United Kingdom Government. Moreover, a compelling case would exist that the nondiscrimination provision in the United States-United Kingdom income tax treaty would be violated. In short, this approach would be offensive to our major trading partners, at least as offensive as the worldwide unitary tax systems adopted by a number of States. Thus, this option has too many adverse international ramifications to be viable.

Let me just conclude by saying that of all of the options in the press release, really none is viable. You are in somewhat of a catch-22 position here in that any substantial legislative change that would raise significant revenue would run squarely into this problem of improving the position of foreign persons who wish to make U.S. acquisitions vis-a-vis U.S. corporate acquirers. Furthermore, it would impact adversely the cost of capital.

Let me point out that under the 1986 Tax Reform Act, many U.S. corporations today cannot deduct interest on their indebtedness. That is because of the major changes involved in the allocation of interest expense. Any company in an excess foreign tax credit limitation position—and that is very many companies today—simply cannot deduct interest on new borrowed funds.

In other words, the situation is already unfavorable, and what we are saying is: Do not make it worse.

Thank you, Mr. Chairman.

Mr. Coyne. Thank you, Mr. Mentz.

Mr. Rice.

Mr. Rice. Thank you, Mr. Chairman. My name is Joe Rice. I am the president of Clayton & Dubilier. I have spent virtually all of my business career in the management buyout business.

Clayton & Dubilier is a private investment firm, which was formed exclusively to do management buyouts. Our principal focus is on subsidiaries and divisions of larger corporations which we believe can be more efficiently managed in a private environment.

Our transactions are never hostile, and we act only in concert with management.

Clayton & Dubilier has available to it a large pool of equity capital. As a general matter, an investment opportunity is pursued only when the business is an established business, when the company and its industry have favorable long-term growth prospects, when the acquisition price bears a reasonable relation to the demonstrated earning power of the business to be acquired, and where a plan of financing can be developed which will permit the business to achieve its growth potential.

Since 1978, Clayton & Dubilier has invested in 15 companies, with aggregate sales of approximately $7 billion and an aggregate purchase price of over $4.3 billion. Each of these businesses is a better business today than it was when it was acquired. The companies have experienced a net increase in sales, in income, in employment, and most importantly, a dramatic increase in productivity.

One of the benefits of operating in the private sector is that it permits you to experiment. One of the things that we have done is to adopt stock appreciation rights plans, which confer on all workers, whether they be salaried or hourly workers, the equivalent of stock ownership. We expect that the utilization of such stock appreciation rights plans will greatly increase the productivity of the businesses with which we are associated.

The success that we have enjoyed is evidence of the fact that buyouts work. What we have done is to produce an environment in which managers can be successful.

A number of the proposals set forth in the press release would obviously not affect the types of transactions which we do. For example, we do not engage in hostile transactions, nor have we used employee stock ownership plans or the assets of pension plans in structuring our transactions.

On the other hand, the proposals addressing the tax deductibility of interest generally have the potential for a major negative impact on American business. We compete in a worldwide market. To the extent that a proposal limits the deductibility of interest generally, it tilts the playing field in favor of the foreign competitor. To the extent the proposal limits the deductibility of interest on acquisition indebtedness, you tilt the playing field dramatically in favor of the foreign acquirer.

Let me make three specific comments. First, with respect to the proposal to disallow interest deductions on debt incurred in connection with a transaction not approved by a majority of the independent directors, the effect of this proposal would be to do away with any truly independent director. Directors would henceforth be chosen not for their judgment and independence, but rather for their unswerving loyalty to the incumbent management.

Second, with respect to the proposal to disallow interest deductions above a specified threshold amount or disallow a percentage of all corporate interest expense, each of these steps would increase the cost of capital. The single most important factor in determining a corporation's long-term investment program is its cost of capital. To the extent that the cost of capital is increased, longer term investment programs will be restricted—just the opposite of the desired effect.

And finally, with respect to the proposal to impose a penalty on an abnormal capital structure, I believe that this would have the effect of doing just exactly what we do not want to do, which is to penalize the most rapidly growing and flourishing corporations.

Thank you very much.

[The statements of Mr. Mentz and Mr. Rice follow:]

TESTIMONY OF J. ROGER MENTZ ON BEHALF OF CLAYTON & DUBILIER, INC.

BEFORE THE COMMITTEE ON WAYS AND MEANS OF THE U.S. HOUSE OF REPRESENTATIVES

MAY 16, 1989

Mr. Chairman and Members of the Committee. It is my pleasure to appear before the Committee once again on behalf of Clayton & Dubilier, Inc. Accompanying me is Joseph L. Rice III, the President of Clayton & Dubilier. As you may recall, we testified previously before this Committee on March 14, 1989 on the tax policy aspects of mergers and acquisitions.

I. INTRODUCTION

Clayton & Dubilier is a highly successful management buyout firm that since 1978 has acquired 15 companies with aggregate annual sales of approximately $7 billion at an aggregate purchase price of over $4.3 billion. All of these transactions were "friendly," and all are better businesses today than before their affiliation with Clayton & Dubilier. Companies acquired by Clayton & Dubilier have experienced a net increase in employment, and employee productivity has increased dramatically.

In our prior testimony we sought to provide a conceptual framework for analyzing the various legislative proposals to alter the tax treatment of corporate finance transactions. In this testimony we will analyze the options detailed in the Committee's press release of April 12, 1989 (the "Press Release"). I will undertake to provide the tax policy analysis and Mr. Rice, in separate testimony, will discuss the practical business implications of certain of the proposals.

II. SUMMARY OF MARCH 14, 1989 TESTIMONY

A. Debt And Equity Are Not Equivalent

In our prior testimony we identified the basic differences between debt and equity. Debt generally requires a fixed schedule of repayment of principal and interest and, in the event of default, usually provides rights for the holder to accelerate the maturity of the obligation, realize on any security, and potentially force the borrower into bankruptcy. Equity, by contrast, does not involve similar remedies in the event of nonpayment of dividends -- generally the most severe remedy is the election of one or two members to a board of directors. Accordingly, the generally recognized tax advantage of financing a business with debt must be balanced off against the disadvantage that over-leveraging could cause a default and bankruptcy which could result in the loss of the enterprise.

In summary, debt and equity are not interchangeable; there are significant economic differences between the most junior subordinated debt and the most senior preferred stock.

B. Deductibility Of Interest Is A Fundamental Concept For Computing Economic Income

The tax systems of virtually every industrialized country in the world that imposes a tax on net income allow a deduction for interest incurred on borrowed funds used to finance a trade or business.[1] In other words, in a net income tax system interest on bona fide debt incurred to finance the business is deductible as a cost of doing business, just like ordinary and necessary business expenses such as rent, salaries, accounting expenses, etc. Thus, the relevant tax policy issue is not whether some portion of interest on bona fide debt should be non-deductible, but rather how the tax law should distinguish between indebtedness, the interest on which is deductible, and corporate equity, for which a deduction is not allowed with respect to dividends paid, at least in the U.S. two-tier tax system.

C. Legal Distinctions Between Debt And Equity

A substantial body of case law has developed over the last forty years in which courts have drawn distinctions that result in classification of corporate securities as either debt or equity in a wide variety of factual circumstances.[2] Under current law a debt instrument that has substantial equity features, if challenged by the Internal Revenue Service ("IRS"), will be scrutinized by a court which will examine in detail the particular provisions of that financial instrument and make its own determination as to its status as debt or equity. There is no bright line rule distinguishing between debt and equity under U.S. law. This is a beneficial state of the law from a tax policy viewpoint, since a bright line rule always permits aggressive taxpayers to come right to the very edge of the law.

D. Concerns That Could Apply To Any Legislative Proposal Disallowing Interest Deductions

We raised five separate problems that would have to be considered in analyzing any legislative proposal to disallow interest deductions. These are as follows:

1. Competitiveness With Foreign Firms. Any legislative approach to limit interest deductions in the United States could produce a material advantage to foreign companies which would be entitled to an interest deduction in their foreign jurisdictions. These foreign companies would be able to bid more for a U.S. business than would a U.S. buyer whose interest deductions would be statutorily limited.

2. Financial Institutions. Separate rules would be necessary for financial institutions.

3. Cost Of Capital. A quantitative analysis of the impact of any proposal on the cost of capital in the United States as compared to the cost of capital in other industrialized countries would be necessary.

4. Revenue Effects. The revenue effects of a proposal would have to be carefully analyzed, and any long term positive revenue effects would have to be balanced with short and medium term adverse effects if harm in financial markets could result from the proposal.

5. Transition Rules. Transition rules will be particularly difficult in the case of interest deductibility, as

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[1] Under generally accepted Schang-Haig-Simmons definitions, interest paid on indebtedness to finance a trade or business must be deducted to arrive at economic income. Goode, "The Economic Definition of Income," Comprehensive Income Taxation, pp. 22-23. (The Brookings Institution: J. Pechman ed. 1977).

[2] A number of these cases are discussed in Exhibit B to our prior testimony before the Ways and Means Committee on March 14, 1989.

businesses have been financed with debt since long before the income tax was instituted.

III. OPTIONS CONTAINED IN THE COMMITTEE PRESS RELEASE

A. General Comments

The Committee has set forth a large number of options that, if enacted, would have a major effect on corporate finance in America and throughout the world. Enactment of any of the proposals (as will be detailed below) would affect the value of all American corporate businesses in the marketplace. For example, if a fixed percentage of all interest payments were made nondeductible, transactions for the purchase and sale of corporations would undoubtedly continue, but the prices would be dramatically reduced. Thus, a substantial change in tax law will affect existing values of corporations. This is true even if there are liberal transition rules. Indeed, fundamental changes in the tax law, whether involving corporate finance or any other feature of the tax law, always have a retroactive aspect, even if enacted with generous effective dates and transition rules.

B. Options Modifying The Current Tax Treatment Of Corporate Interest

Before addressing the specific options listed in the Press Release, the following observations are in order.

- **Administration Witnesses Have Not Recommended A Limit On Interest Deductibility.** No Administration witness testifying previously before the Ways and Means Committee, Senate Finance Committee, or in any other Congressional hearings recently held on this subject, has recommended a modification in the tax treatment of corporate interest. Treasury Secretary Nicholas F. Brady has recommended no action on this subject. Assistant Secretary of Labor David M. Walker, Treasury Tax Legislative Counsel Dana L. Trier, and Executive Director Kathleen P. Utgoff, Pension Benefit Guaranty Corporation, expressed no legislative recommendation regarding the impact on LBOs on pension plans. Federal Reserve Chairman Alan Greenspan strongly disapproved of any legislative disallowance of interest deductions. FDIC Chairman William Seidman and SEC Chairman David Ruder also opposed any change in interest deductibility on business indebtedness.

- **Interest Deductibility Proposals Would Favor Foreign Acquirers.** All proposals that would substantially restrict or eliminate the current tax treatment of corporate interest paid by U.S. corporations necessarily will provide an advantage to foreign firms that wish to acquire U.S. businesses.[3] This is because deductions are available in other jurisdictions for interest paid on debt incurred, directly or indirectly, to finance a U.S. acquisition.[4] Federal Reserve

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[3] For many U.S. corporations, interest on indebtedness is not deductible under current U.S. law. This is because borrowing by U.S. businesses with foreign activities will often result in the allocation and apportionment of interest deductions to foreign source income, thereby reducing the taxpayer's foreign tax credit limitation, which is equivalent to a loss of the interest deduction if the corporation is in an excess credit position.

[4] See Exhibit D of our prior testimony which describes the interest deduction rules of France, the United Kingdom, Canada, Japan and West Germany.

Chairman Alan Greenspan explicitly acknowledged that this was a most troubling aspect of proposals to limit U.S. interest deductibility. This problem is insoluble, as detailed in our testimony at E infra.

° **Below Investment Grade Debt Is Common In Corporate America.** The overwhelming majority of American businesses are financed with debt that is below investment grade.[5] If interest on below-investment-grade debt incurred to finance a business were disadvantaged, small and medium size businesses throughout America would be severely impacted.

° **Other Forms Of Financing, Such As Leasing, Would Have To Be Addressed.** If elaborate rules are constructed to disallow corporate interest deductions, other forms of financing would also have to be addressed legislatively. For example, if only interest deductions were affected, corporations subject to the limitations would finance their business assets through leasing or licensing rather than purchase.[6] Obviously, additional complexity would be involved to legislate restrictive rules for leasing and licensing in the same fashion as interest.

° **Advantage For Avoiding Corporate Form Of Organization.** The Press Release options relate only to the deductibility of corporate interest expense. If non-corporate interest payments on debt incurred to finance a business were to remain fully deductible, a powerful advantage would be created in favor of disincorporation or organization of new businesses in non-corporate form.

° **Allowance Of Dividend Received Deduction With Respect To Disallowed Interest.** Any suggestion that interest be nondeductible, in whole or in part, must presumably be because the payment is implicitly a return on equity rather than debt. If this is so, then that amount for which an interest deduction is disallowed should be considered as a dividend, with the normal tax consequences that flow from such characterization, including particularly the allowance of a dividend received deduction to any corporate holder of the instrument with respect to which the payment is made. Thus, a pure disallowance of the deduction for interest paid without an accompanying dividend received deduction has no conceptual basis and may result in triple taxation of corporate income.

° **Retroactive Effect On Value Of Corporate America.** Although the options that would modify the current tax treatment of corporate interest are far reaching and would have a profound effect on corporate America, none would eliminate leveraged buyouts and other corporate acquisition transactions. Rather, we believe that transactions would continue under any of the options, but at a very different price. The economic effect, of course, would be felt by those persons owning interests in corporate America, whether directly, or indirectly through mutual funds, pension funds or otherwise. To restate the point made above, no matter what effective dates and transition rules are chosen, enactment of any of these proposals would affect retroactively the value of corporate business.

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[5] According to "A Comparison of Investment and Non-Investment Grade Companies in the United States," prepared by Drexel Burnham Lambert, May 1988, only 1,111 of the 22,214 corporations that might contemplate a public sale of debt have received or could receive an investment grade rating. The remaining 21,103 corporations represent all segments of the nation's economy.

[6] This point is implicitly noted in the parenthetical at the bottom of page 5 of the Press Release.

Analysis Of Specific Options In Part B Of Press Release

1. Disallow Interest Deductions On Debt Incurred In A Hostile Tender Offer

This proposal would provide the "independent" members of a board of directors (which often are not truly independent but are aligned with management) with the ability to resist a takeover that may be beneficial for the shareholders and the company, purely on the basis of tax implications. In effect, by enacting this proposal Congress would be legislating a form of "shark repellent" that poorly managed corporations could use to resist acquisitions that would otherwise have the beneficial effect of clearing out the deadwood and returning the corporation to a productive, competitive existence. We note that Assistant Secretary of the Treasury for Tax Policy Ronald A. Pearlman has testified in opposition to this proposal.[7] He questioned, as do we, whether a clear distinction between "hostile" and "non-hostile" transactions can or should be legislated.[8]

2. Deny Interest Deduction For Mergers Not In The Public Interest

This proposal would subject every acquisition to a separate evaluation to be conducted by the Federal Trade Commission ("FTC") to determine whether the transaction will result in a significant loss of jobs.

We believe that the FTC should not be in the position of making determinations that have material tax law consequences. We further believe that this proposal is inconsistent with the philosophy behind the Tax Reform Act of 1986 under which many provisions implementing social policies were removed from the Internal Revenue Code.

3. Disallowance Of Interest Deduction Above A Specified Threshold Amount

This proposal is aimed at the disallowance of interest deductions on noninvestment grade debt. As noted above, much of corporate America is financed with noninvestment grade debt. We believe that before any action is taken on this proposal, an analysis should be undertaken to ascertain the impact on the value of firms that issue below investment grade debt. We suggest that a very broad cross section of corporate businesses would lose significant value if this proposal were enacted.

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[7] Tax Aspects of Mergers and Acquisitions: Hearings Before the Subcommittees on Oversight and Select Revenue Measures of the House Committee on Ways and Means, Serial 99-27, 99th Cong., 1st Sess. 267 (April 1, 2 and 16, 1985) ("Hearings").

[8] This point was also made by David H. Brockway, Chief of Staff, Joint Committee on Taxation, at the same hearing. Hearings at 188.

4. Disallowance Of A Percentage Of All Corporate Interest

As noted above, there is no tax policy reason for disallowing a flat percentage of all interest expense of all corporations. The AAA-rated corporation that borrows from a bank to finance its inventory and accounts receivable is entitled to deduct the interest on that borrowing, just as that same corporation is entitled to deduct the cost of the rent or salaries that it pays, as well as the expenses of its telephone system, rent for its computers, and other ordinary and necessary business expenses. Despite the superficial appeal of this proposal to equalize debt and equity, the fact is that debt and equity are not equivalent. The bank loan to finance the corporation's inventory and accounts receivable is not the same as that corporation's common stock, and the tax consequences of payments with respect to each should not be the same. To our knowledge the tax consequences for debt and equity are not the same in any country of the industrialized world.

5. Shareholder Credit For Corporate Tax -- Disallowance Of Interest Deduction

This proposal would disallow all interest deductions, apparently not on the theory that the debt is equity, but on some unknown rationale. The equalizing tax benefit in this proposal is a credit to shareholders with respect to dividends paid for all corporate taxes paid. This would result in a substantial increase in corporate tax because interest deductions on all bona fide debt would be disallowed. For corporations that pay modest or no dividends, the offsetting credit would be of little or no value. This proposal would have an enormous negative impact on the value of corporate America.

We question how this proposal could be administered. It goes well beyond any system of corporate-shareholder integration in place in any European country, because the tax paid by the corporation would be based on an amount that would always exceed the corporation's true net income. Thus the credits to shareholders would be extremely large, and may not be useable by the shareholders in full, even if all earnings are distributed.

6. Disallowance Of Interest Deduction In Excess Of A Specified Rate

Any disallowance of interest deductions in excess of a specified rate would have unfavorable consequences for particular businesses that may be compelled to finance their business with high rate debt. This proposal is similar to proposal 3 involving the disallowance of interest on so-called "junk bond" debt, and our comments above are equally applicable here.

We question the reference to structured finance techniques. If a corporate obligor were to borrow at a percentage rate below the statutory cut-off rate, we do not understand why the subsequent structuring of that debt by a third party into a trust, collateralized mortgage obligation-type of entity, or other structure to take advantage of the yield curve should result in non-deductibility.

7. Establish Normative Level Of Debt To Equity Ratio

The major problem with establishing any arbitrary debt-to-equity ratio is that no "norm" exists. Norms would be different for different industries, and of course many corporations are engaged in multiple industries. Furthermore, even within an industry, debt-to-equity ratios vary widely.

8. Annual Percentage Deduction Based On Overall Capitalization

This proposal would disallow all interest deductions and replace them with a deduction as a percentage of the overall capitalization of a company, presumably only to the extent that such amount was paid out to debt holders and stockholders. This proposal would be very complex and suffers from the basic flaw that it does not permit a deduction for interest expense on bona fide debt incurred to finance a trade or business.

9. Disallowance For OID

Original issue discount ("OID") is treated in the tax law as equivalent to interest -- it is accrued and deducted by the corporate obligor and included in income of the obligee on a economic accrual method irrespective of when paid.[9] We believe that the current tax treatment of OID is correct, and that this proposal is not sound as a matter of tax policy. In the case of a creditworthy obligor, OID is the equivalent of interest and should be deductible, as interest should be deductible, on debt incurred to finance a business. We agree that amounts characterized as "OID" that may never be paid because of the obligor's uncertain financial status should not be deductible in some cases; we believe, however, that a court could come to this conclusion under current law.

We do not believe that tax exempt entities and foreign persons should be singled out for a rule that would disallow deductions for OID with respect to their holdings. Assuming that the obligation is bona fide, there is no reason to treat OID differently than interest, and in particular, there is no reason why tax exempt entities or foreign persons should affect the deductibility. We also note that such an approach would be virtually impossible to administer, as the OID deduction would in theory fluctuate depending upon the ownership of the obligations. In reality, corporations do not generally know the ownership of their publicly-held debt or shares.

Treatment of OID as unrelated business income to tax-exempt holders has no policy rationale. Similarly, full taxation of foreign holders on OID, which presumably means 30% withholding, has no policy justification (for a discussion of the 30% withholding tax generally, see E2 infra).

C. Integration Proposals

The Press Release contains three suggestions for integrating the corporate and shareholder income tax systems. Many of our major trading partners have achieved a partial or complete integration of the corporate and individual tax systems. One critical point must be noted -- not one of those integration systems is financed through the disallowance of interest deductions. Indeed, there is no more logic to denying interest deductions to finance corporate-shareholder integration than denying deductions for salaries, rents, telephones, etc. Thus while the integration of the corporate-shareholder tax systems may be desirable, we believe it is not desirable if it is paid for through the disallowance of interest deductions.

Despite best intentions, we further question whether in the world of Gramm-Rudman-Hollings budget pressures, corporate-shareholder integration could be achieved. Any such proposal, however financed, could be bifurcated in the subsequent legislative process, with the result that the integration proposal is discarded and the revenue raiser is included and spent for other purposes.

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[9] Changes in the tax law in 1984 achieved this economic accrual result. See Deficit Reduction Act of 1984, § 41(a) adding section 1272 of the Code.

D. Options Relating To Investment Banking Fees

The Press Release contains a proposal to impose excise taxes on investment banking and other fees earned in leveraged buyouts. We question the conceptual merit of such excise tax proposals.

The theory for any excise tax is that it is intended to compensate for the external social costs associated with the production or consumption of a good or service. In general, the free market will efficiently allocate economic resources so that, at the margin, all of the economic costs to society of the good or service are reflected in the price charged by the producer, and all of the economic benefits to society are reflected in the price paid by the consumer. In some cases, however, the social costs of producing or consuming a particular good or service exceed the cost to the producer or consumer. These external, uncompensated costs are borne by other members of society who do not directly benefit from the production or consumption of the good or service. When external costs are present, such as the health and social costs associated with tobacco and alcohol, the imposition of an excise tax can make the allocation of economic resources more efficient by raising the price of the offending activity and thereby internalizing the external cost.[10]

We are aware of no body of economic literature or authority that regards the services rendered by financial and legal advisers in connection with the transfer of businesses to be, in general, a form of activity that involves these "negative externalities" so that an excise tax should be imposed on the service. Indeed, we believe that most economists would regard an excise tax on services performed in professions involving very substantial free market competition among firms as being disruptive of the efficient allocation of economic resources.

1. Excise Taxes On Compensation Derived By Any Party In An LBO

The non-deductible excise tax on compensation derived by "any party" earning income in a leveraged buyout is very broad. It obviously would apply to any investment banker but would also apply to all corporate employees who worked on the transaction, lawyers (including associates and secretaries who are paid a salary by the law firm involved), the proxy solicitors, and, conceivably even a taxi driver available for round-the-clock duty for one of the parties as the transaction is negotiated and consummated.

Another not insubstantial issue is the definition of a "leveraged buyout."

The additional 20% fee on a "managing investment banking firm and other leveraged buyout manager" is so substantial that parties to the transaction that could fall in the ambit of this provision would attempt to rearrange transactions to avoid it. For example, instead of taking a fee in cash, participants may become more substantial partners in the resulting entity, and realize their profits subsequently when the business is sold or taken public. If this is not possible, the fees in the transactions may increase in order to offset the economic effect of the excise tax. This would, of course, affect the value of the corporate business being sold.

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[10] See generally, Statement of J. Roger Mentz, Assistant Secretary (Tax Policy), Department of the Treasury, before Senate Committee on Finance, April 21, 1986, at 14.

This fee could be analyzed as a selective payroll tax. As such, it is clearly a new tax. Furthermore, the concept of a selective excise tax on particular types of income is highly dangerous. A similar concept could be extended to any form of lawful compensation which was politically out of favor -- such as income of corporate executive whose employers do business in South Africa, or oil tanker captains who run their vessels aground. We note that as a result of the Tax Reform Act of 1986, all compensation paid is subject to income taxation at either a 15% or 28% rate, and the ability for individuals to shelter large amounts of earned income is practically non-existent. This selective payroll tax would constitute a departure from Tax Reform, where all income, including capital gains, is taxed in the same fashion.

2. Fifty Percent Excise Tax On Compensation In Excess Of $50,000,000 A Year Earned By Individuals

We question whether any individual will ever again earn $50,000,000 or more personally in one taxable year as compensation for services rendered in connection with merger and acquisition activity. We assume this proposal does not apply to capital gains from a leveraged buyout investment even if the investment itself was received (and taxed) as compensation.

3. "Two-tiered" Fee Structures

We think "two-tiered" rate structures for advisory fees based on the success of an offer present a regulatory problem that should not be dealt with through the tax system.

E. Options Relating To The Tax Treatment Of Foreign Persons And To Issues Of Foreign Investment

The options described in part E of the Press Release are apparently intended to counteract the bias that would be created through a limitation on interest deductibility in favor of foreign acquirers that could deduct interest in a foreign jurisdiction. All of the proposals in this section have serious policy and technical problems. We do not believe that the problem of foreign competition that would be created through the enactment of a significant interest restriction is soluble. We base this statement on our in-depth study of the deductibility of interest provisions of the foreign laws (appended to our prior testimony).

1. Additional Tax Of U.S. Corporation Acquired By Foreign Person To Account For Interest Incurred Outside The United States

This option would include an additional amount in a U.S. corporation's taxable income by reason of a foreign interest deduction taken by a foreign affiliate. The amount of the inclusion apparently would depend upon the amount of interest paid by a related foreign corporation that would have been disallowed if paid by a corporation subject to U.S. tax. This approach would require an allocation of the foreign controlling corporation's worldwide interest expense to the investment in the U.S. corporation. For example, under this proposal if British Petroleum ("BP") were to acquire a corporation in the United States, an allocation would be made of all of BP's worldwide interest expense (including BP's affiliates) and a determination made as to how much of that expense should be allocated to the

U.S. acquisition. This analysis would occur even though BP is not a U.S. corporation and is not engaged in business in the United States. The allocable amount of BP's interest, if greater than the interest paid by the U.S. corporation whose deduction is disallowed, would be included as income to the U.S. corporate subsidiary of BP.

Obviously, compliance and administrability of this provision would be extraordinarily difficult. The IRS would be unlikely to convince BP to submit to a worldwide audit. Furthermore, much of the debt would be incurred in foreign currencies -- the Press Release requires converting to U.S. dollar interest rates, noting that "anticipated foreign exchange gains and losses" would have to be taken into account. The Press Release further states that if the foreign corporation (BP) failed to properly account for its worldwide interest payments, there would be a mandatory income inclusion. Finally, the statement is made that exceptions would be made only where the Treasury Department certifies those countries that have "effective" interest deduction rules.

Such an approach would in all likelihood be insulting to the U.K. Government. Moreover, a compelling case would exist that the non-discrimination provision of the U.S.-U.K. income tax treaty would be violated.[11] This approach would be at least as offensive to our major trading partners as the "worldwide unitary" tax systems devised by a number of states. Existing and future trade and tax relationships with foreign governments would be jeopardized.

In short, this option has too many adverse international ramifications to be viable.

2. Impose A Withholding Tax On Interest Paid To Foreign Persons On Portfolio Debt

This proposal is unrelated to the advantage which would be obtained by foreign persons seeking to acquire U.S. businesses if U.S. tax law is changed to limit interest deductions. Such an acquisition would typically be accomplished by a foreign parent corporation borrowing in whichever debt market it chooses, but would not typically involve any borrowing by the U.S. entity in the Eurodollar market. Thus, this proposal is unrelated to the foreign competitive advantage discussed above.

Moreover, this proposal would destroy the ability of U.S. corporations to borrow in the Eurodollar market. Thus, rather than assist the U.S. corporations desiring to make acquisitions which are disadvantaged by some new interest disallowance rule, this would adversely affect the same U.S. corporations.

Contrary to the implication of the Press Release, during the last 25 years U.S. corporations have borrowed in the Eurodollar market without imposition of any U.S. withholding tax. This has been accomplished with the consent of the IRS and the Congress. During the 1960's withholding tax was avoided through the use of international finance subsidiaries, incorporated either in Delaware or the Netherlands Antilles.[12] For a period in the early 70's and again since 1984 there has been a direct statutory exemption from interest withholding for portfolio debt issued in the Eurodollar market. During the remainder of the 1970's and early 1980's, the international finance subsidiary technique was again utilized. Thus U.S. corporations have been able to borrow in the Eurodollar market for the last 25 years without U.S. withholding tax.

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[11] See Article 24, Section 5, Convention Between the Government of the United States of America and the Government of The United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital Gains.

Although the withholding tax is nominally on the lender, the market compels the borrower to bear the withholding tax economically and, indeed, to gross up the lender for any withholding tax incurred. Accordingly, the imposition of the withholding tax, whether it be 30% or 5%, would in most cases make a borrowing by a U.S. corporation of Eurodollars uneconomic as compared to a domestic borrowing. Thus the effect of this proposal would not be to raise revenue, but rather to curtail the ability of U.S. borrowers to find, in some instances, cheaper borrowing in the Eurodollar market.

If an exemption is not provided for United States government debt, the borrowing costs of the United States government will increase substantially. The fact that an exemption is an economic necessity for the U.S. government but is not allowed for corporate borrowers highlights the lack of policy rationale for the proposal.

3. Disallow Interest Deduction For "Earning Stripping" Transactions

This proposal would disallow a deduction for interest paid to related parties that exceeds a threshold percentage of the corporation's taxable income. The apparent intent would be to disallow the deduction with respect to interest that would not be subject to U.S. tax by the recipient. Thus, this proposal is similar to B9, limiting deductions for OID where the recipient is either a tax exempt entity or a foreign holder. The administrability of this provision would be less difficult than the OID proposal since it apparently would apply only to interest paid to related parties.

When a payment is made to a related party that is subject to tax in a foreign jurisdiction, particularly a treaty jurisdiction, there is no tax policy reason for the interest deduction to be disallowed, as the income is subject to taxation to the recipient. Even where the foreign jurisdiction may not have a full income tax, the likelihood is that the income to that corporation will be Subpart F income and thus the net amount will be taxable in the United States.

This proposal, if applicable to interest paid on previously outstanding debt, would affect Eurodollar financings previously done through an international finance subsidiary where interest is paid by the U.S. borrower on debt held by its subsidiary; typically the finance subsidiary itself pays out an amount of interest to its debt holders (which debt is guaranteed by the U.S. parent), and thus the total arrangement is effectively a borrowing from third parties by the U.S. corporate group. There is no reason to disallow interest deductions in this context. This proposal would require refinancing of those outstanding Eurodollar issues done through an international finance subsidiary, with attendant market disruption.

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[12] See A Report On International Finance Subsidiaries, New York State Bar Association Tax Section, 28 Tax Law Review 439 (1973).

We note that a similar proposal was made by the Senate Finance Committee in the 1986 tax reform markup but was wisely abandoned.

4. Allow Amortization Deduction For Good Will

Because of revenue considerations we doubt this is a viable proposal.

We do not understand how the subject of favorable foreign tax treatment of good will expenses could be dealt with in a treaty context.

5. Tax Gain Realized By Foreign Persons With Respect To U.S. Corporate Stock

This proposal recommends the taxation of gain realized by a foreign person on the liquidation of a U.S. corporation as a dividend to the extent of the corporation's earnings and profits. One version of this proposal would override existing treaties.

Such a proposal by itself would be totally ineffectual, since every foreign person prepared to liquidate a U.S. corporation would sell the shares to a third party (United States or foreign) which would then complete the liquidation. Little gain would be realized on that liquidation, and accordingly virtually no effect would occur as a result of this proposal alone. The last sentence of this proposal, however, would broaden it substantially by requiring that foreign persons who realize gain on the sale of any stock in a U.S. corporation be subjected to taxation as if having received a dividend to the extent of their share of the earnings and profits of the U.S. corporation. In effect this would be a "reverse section 1248" approach whereby sales of U.S. corporate stock by foreign persons would be bifurcated into part dividend-part capital transactions.

This approach would be very difficult to administer, since publicly held U.S. corporations are generally not aware of the identity of their shareholders. Furthermore, foreign persons could avoid the tax by holding the shares of U.S. corporations in separate foreign corporations and simply selling the holding company shares. In order for any such tax to be administratively feasible, some withholding concept would be necessary such as exists for FIRPTA.[13] This would impose a significant burden on U.S. corporations.

Obviously, this proposal would be severely adverse to the U.S. stock exchanges and the U.S. capital markets generally.

F. Options Modifying The Tax Consequences Relating To Certain Corporate Financing Transactions

1. Non-Deductible Excise Tax On Stock Or Asset Acquisitions

This proposal would impose an excise tax on either asset or certain stock acquisitions -- the rate of 3% to 5% is suggested. If it were imposed on all acquisitions, the effect would be to alter the economics of every acquisition transaction and make uneconomic some currently viable transactions that would result in a favorable rearranging of corporate assets. Any limitation on the proposal to hostile takeovers suffers from the same definitional infirmity noted above, and would be another form of "shark repellent" that would assist in entrenching corporate management.

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[13] See Section 1445 of the Code, as added by P.L. 98-369.

Because of budget constraints we question whether revenues raised by this tax would be used for a "revolving fund to help small business and venture capital situations."

2. Fifty Percent Exclusion For Certain Gain On The Sale Of Assets

This proposal presumably would lose revenue. Consideration of this proposal should be in the context of the capital gains discussions, not in this context.

3. Recognize Gain On Borrowing And Distribution Of Proceeds To Shareholders

This proposal would apply to the extent that appreciated assets are borrowed upon and the proceeds distributed to shareholders, to the extent that the distribution exceeds the amount of shareholders' contribution to capital plus accumulated earnings of the corporation. This is a somewhat targeted proposal directed to a corporation that leverages its assets and makes a substantial non-dividend distribution. There are numerous questions that the proposal leaves unanswered, including how existing debt that is secured by corporate assets would be treated if a subsequent borrowing were incurred that was not secured by the assets, and whether any nondividend distribution would be presumed to be linked with any secured corporate borrowing so that the tax would apply.

We question why gain should be recognized with respect to assets that are not in substance sold or distributed. We do agree, however, that if the effect of a borrowing and pledge of assets is an economic sale, that gain should be recognized. We believe that a court would so find under current law.

G. ESOPs

Clayton & Dubilier has never used an ESOP in financing or selling its businesses. In recent acquisitions Clayton & Dubilier has given all employees a direct stake in the company through the issuance of stock appreciation rights. We therefore leave the tax policy discussion of ESOP issues to those who have a more direct interest in them.

H. Miscellaneous

This section contains various suggestions for dealing with the regulatory aspects of mergers and acquisitions. For example, suggestions are made that the defense period for outside takeovers should be increased to 60 days and that the period in which competing offers can be made during a management buyout could be increased to 90 days.

Irrespective of whether these regulatory proposals have merit, it is inappropriate to implement such proposals through the tax law. A basic policy of the 1986 Tax Reform legislation was to limit the function of the tax laws, to the extent possible, to raising revenue in the most neutral fashion, and not to implement social or other policy goals through the tax law. If these suggestions are meritorious, they should be acted upon as regulatory matters, but compliance or non-compliance should not have tax consequences.

IV. CONCLUSION

The Press Release articulates a myriad of proposals that would affect the tax consequences of mergers and acquisitions. We believe we have articulated significant tax policy detriments of each.

In addressing this subject, the Committee first needs to identify what problem exists that it wishes to remedy. Defining the problem is difficult because of these reasons:

° **Some Leveraged Buyouts Prove To Be Beneficial, But Some Do Not.** While we believe that ths transactions accomplished by Clayton & Dubilier create new jobs, improve the productivity of the enterprises acquired and the economies of the locations where they operate, we would agree that not every acquisition is socially or economically beneficial.

° **Leveraged Buyouts Are Not New.** They are variations on the corporate acquisition theme which has been occurring for many years. Indeed, the Chairman of the Senate Finance Committee acknowledged that one of his first business transactions was a leveraged buyout.

° **Leveraged Buyouts Are Not Caused By The Tax Laws.** Indeed, although taxes are an important economic consideration, it is worth noting that leveraged buyouts and other corporate acquisitions are less tax advantaged after the Tax Reform Act of 1986 than they were previously.

° **Revenue Estimates Are Especially Imprecise.** Estimating the revenue consequences of leveraged buyouts, and any proposal to change the tax treatment thereof, is difficult. Nevertheless, a highly regarded Harvard Business School professor has concluded that leveraged buyouts produce a revenue gain to the U.S. Treasury.[14]

Our principal concern is that a solution not be devised that is substantially worse than any of the perceived problems. In this regard, we again direct your attention to the following serious problems with the proposals included in the Press Release.

° **Effect On Value.** Many of the proposals would seriously erode the values of corporate America and thus have a very real retroactive economic effect.

° **Foreign Advantage.** Any substantial limitation on the deductibility of interest will create a real advantage to foreign investors which can obtain a deduction in a foreign jurisdiction. This difficulty is not solved by any of the proposals in the Press Release.

° **Cost Of Capital.** The impact of any proposal on the cost of capital must be quantitatively evaluated. No serious legislative consideration of any proposal should be made without this input.

° **Financial Institutions.** Some special rules must be developed for financial institutions, since any disallowance of gross interest expense for a financial intermediary could well produce liability far in excess of net income; such separate disparate treatment would create a "cliff effect," depending upon whether a taxpayer did or did not qualify for relief as a financial institution.

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[14] Jensen, Kaplan & Stiflin, "Effects of LBOs on Tax Revenues of the U.S. Treasury," Tax Notes, February 6, 1989, at 727.

- **Transition Rules.** Any set of transition rules dealing with a disallowance of interest deductions on debt incurred to finance a business, which interest payments have been deductible since before the commencement of the income tax, would be extraordinarily difficult.

- **Effect On Financial Markets.** The adverse impact of any proposal that has a realistic chance of becoming law on the financial markets must be considered.

The President of Clayton & Dubilier, Joseph L. Rice III, will now present the analysis of how the options in the Press Release would affect Clayton & Dubilier, and what their practical effect would be on management buyouts generally. When his testimony is concluded, we would be pleased to answer any questions.

TESTIMONY OF JOSEPH L. RICE, III
PRESIDENT OF CLAYTON & DUBILIER, INC.

BEFORE THE COMMITTEE ON WAYS AND MEANS
OF THE U.S. HOUSE OF REPRESENTATIVES

MAY 16, 1989

Mr. Chairman and Members of the Committee, it is my pleasure to appear before the Committee to express my views regarding the practical impact of the proposals set forth in the Committee's Press Release of April 12, 1989. I have been engaged in the management buyout business for some 23 years, since long before it was a business. I am now the President of Clayton & Dubilier, Inc. Prior to joining Clayton & Dubilier in 1978, I was a founder of the first firm devoted exclusively to leveraged buyout transactions. Before entering the management buyout field, I was engaged in the practice of corporate law with Sullivan & Cromwell.

I. BACKGROUND

Clayton & Dubilier is a private investment firm devoted exclusively to management buyouts. Since we began in 1978, our focus has been on the purchase of private companies and divisions of larger corporations that we believe can be more efficiently managed. Our transactions are never hostile; we only act in concert with management.

Clayton & Dubilier has a large pool of equity capital available for investment in its management buyout transactions. As a general matter, an investment opportunity is pursued only when: (1) the business is an established business; (2) the company and its industry have favorable long-term prospects and the potential for significantly better financial performance through better management; (3) the acquisition price bears a reasonable relation to the demonstrated earning power and prospects of the business; and (4) a plan of financing can be developed which will permit the business to achieve its growth potential.

Clayton & Dubilier and management are partners. As such, we share common goals: to obtain the financing most appropriate to the current and future financial needs of the acquired business; to pay down the debt in accordance with its terms; and to foster the long-term success of the new company. The principles which guide our firm's approach to any investment are that the capitalization of an acquired business must be consistent with its long-term operating needs and that management must have a substantial stake in the enterprise.

Although each of our transactions is unique, the financing for an acquisition generally is structured as follows: (1) senior debt, provided by a syndicate of banks, represents 50-60 percent of the purchase price; (2) subordinated debt represents 30-40 percent of the purchase price; and (3) equity, including management's investment and our investment, represents 10-20 percent of the purchase price. The bank debt generally has a life of seven to eight years and the subordinated debt a life of 10 to 15 years.

Since 1978, Clayton & Dubilier has acquired 14 companies with aggregate annual sales of approximately $7 billion at an aggregate purchase price of over $4.3 billion. Each of these businesses is a better business today than when we acquired it. The companies have experienced a net increase in employment, and employee productivity has increased dramatically. One of the benefits of operating in the private sector is that it affords you the opportunity to experiment; in our most recent acquisitions, all employees (both salaried and hourly) have been granted "stock appreciation rights," the economic equivalent of an ownership interest in the business. We believe that making available to all employees "a stake in the business" will greatly increase productivity.

The success of Clayton & Dubilier is due in large part to our personnel. Members of our firm have held senior management positions with major public and private companies representing a broad range of industries, products, and technologies, while others have had substantial experience in law, banking, and finance. Thus, Clayton & Dubilier brings to every transaction a distinctive group of professionals with complimentary strengths.

We have provided full information on all of Clayton & Dubilier's transactions to the Joint Committee on Taxation, and Exhibit A attached to my testimony summarizes the relevant statistical information. I would be pleased to provide you or your staffs with any other information with respect to these acquisitions that you deem relevant.

II. PRACTICAL IMPACT OF OPTIONS CONTAINED IN THE COMMITTEE'S PRESS RELEASE

A. General Comments

A number of the proposals set forth in the Press Release would not directly affect the types of transactions conducted by Clayton & Dubilier. For example, we do not engage in "hostile" transactions nor have we used employee stock ownership plans or the assets of qualified pension plans in structuring our transactions.

On the other hand, the proposals addressing the tax deductibility of interest generally have the potential for a major negative impact on American business. We compete in a worldwide market; to the extent that a proposal limits the deductibility of interest generally, you tilt the playing field dramatically in favor of all foreign competitors; to the extent that the proposal limits the deductibility of interest on acquisition indebtedness, you tilt the playing field dramatically in favor of the foreign acquirer.

B. Analysis Of Specific Options In Part B Of Press Release

My Counsel in accompanying testimony has provided detailed comments specifically addressing each proposal described in the Press Release. I will address only a few selected proposals.

1. Disallow Interest Deductions On Debt Incurred In Connection With A Transaction Determined To Be Hostile

The effect of this proposal would be to do away with any truly independent directors. Directors would henceforth be chosen not for their judgment and independence but for their unswerving loyalty to the incumbent management.

2. Disallowance Of Interest Deductions Above A Specified Threshold Amount Or Disallowance Of A Percentage Of All Corporate Debt

These proposals would disallow a deduction for a portion of interest paid, either limited to non-investment grade debt or as a percentage of all debt allocated to a corporate acquisition. From a practical standpoint, these proposals would have little effect on the acquisitions of new businesses *if* the denial of deductions for such interest payments were applicable to all investors involved in corporate acquisitions. Because it appears that foreign acquirers and other non-corporate entities would not be subject to such restrictions, however, we believe that these proposals would place U.S. corporations at a severe competitive disadvantage.

3. Tax Penalty For "Abnormal" Debt/Equity Ratio

A business is a dynamic enterprise. For a dynamic and progressive business, there is no "normal" debt to equity ratio. From a practical standpoint, therefore, this proposal would produce an arbitrary standard which would doubtless injure the businesses we most want to have flourish.

III. CONCLUSION

Let me close my remarks on a cautionary note -- to the extent that you legislate in a manner which advantages foreign corporations to the detriment of U.S. interests you do a disservice to all of your constituents.

Thank you for giving me the opportunity to present my views to you. I would be pleased to answer any questions.

Exhibit A

FINANCIAL AND OPERATING DATA OF MANAGEMENT BUYOUTS SPONSORED BY CLAYTON & DUBILIER, INC.

	DATE OF ACQ.	SALES		EBIT		EMPLOYEES		R&D		CAPITAL SPENDING		(h) TOTAL DEBT		EQUITY	
		Prior to Acq.	Cur or Yr of Sale	Prior to Acq.	Cur or Yr of Sale	Prior to Acq.	Cur or Yr of Sale	Prior to Acq.	Cur or Yr of Sale	Prior to Acq.	Cur or Yr of Sale	At Close	Cur or Yr of Sale	At Close	Cur or (1) Yr of Sale
Safeway (UK)	11/87	$ 651.1	$691.1	$ 13.5	$ 28.0	5,222	6,170	N/A (b)	N/A	$ .070	$ 14.0	$ 160.5	$144.0	20.0	26.7
Borg Warner	5/87	275.3	295.3	26.9	38.6	2,879	2,875	$ 5.7	$ 3.5	9.9	5.5	222.0	191.0	20.0	39.9
Nu-Tone	1/87	130.0	140.2	.5	5.2	1,307	1,249	1.3	2.4	5.0	3.3	56.4	51.6	5.0	(4.9)
O.M. Scott	12/86	157.2	197.1	19.9	28.2	868	792	4.1	4.3	3.0	3.7	191.0	125.0	20.0	38.3
Uniroyal (a) Goodrich Tire Co.	6/88	2,064.0	2,200.0	78.0	136.0	19,201	(c) 18,412	49.9	42.0	107.7 (d)	82.0	775.0	693.0	264.4	287.0
Pillsbury	3/85	72.0	95.1	4.7	6.0	1,446	1,366	N/A	N/A	4.5	3.6	36.0	34.8	7.0	9.8
Arnold Foods (Sold 10/86)	3/84	200.2	234.0	5.3	12.5	1,494	1,540	N/A (e)	N/A	5.6	5.5	35.0	27.4	4.7	11.1
Nevamar	7/84	56.0	112.7	6.9	14.0	600	1,032	.786	2.4	2.9	5.5	34.2	45.8	8.5	22.4
Harris Graphics (IPO-10/84; Sold 6/86)	4/83	376.0	496.1	35.0	57.1	4,000	4,300	12.3	18.5	1.7	17.1	206.3	109.0	23.5	84.0
WGM Safety (Sold 10/86)	7/81	34.6	39.5	2.0	4.6	562	565	N/A	N/A	.392	.751	13.1	5.0	3.9	2.5
Stanley Interiors (Sold 3/85)	9/79	92.5	130.5	4.8	11.8	2,523	2,466	N/A	N/A	2.1	1.5	45.3	3.9	6.0	19.0
KUK (f) (Sold 11/85)	2/79	19.2	26.1	1.7	3.2	--	--	--	--	--	--	--	--	--	--
	Total:	4,127.7	4,665.7	200.0	345.2	40,102	40,767	74.086	73.1	142.932	142.451	1,773.0	1,432.1	383.0	535.8

(g)

Exhibit A continued

FINANCIAL AND OPERATING DATA OF MANAGEMENT BUYOUTS SPONSORED BY CLAYTON & DUBILIER, INC.

FOOTNOTES:

(a) Uniroyal, Inc. - all segments of the company were disposed of as independent businesses except for the tire operation which was combined with The B.F. Goodrich Tire Company. Uniroyal was taken private in September 1985. Clayton & Dubilier ("C&D") acted as the "white knight" with Uniroyal management in response to an unfriendly tender offer by Carl Icahn.
(b) N/A = Not Applicable
(c) Hourly employees at 12/31/86 and 11/30/88 were 13,840 and 14,033 respectively.
(d) UGTC '87 depreciation was $51.0MM and is estimated to be $56.0MM in 1988
(e) More relevant to Arnold, a bakery company, is the increase in marketing expenditures during 1984 - 1986 from $7.2MM to $10.1MM respectively.
(f) Kux was sold in a private transaction. Information relating to this company was not available at the time this report was prepared.
(g) Two transactions completed by C&D in late 1988 are not included: The Kendall Company - acquired 10/31/88 and the Hyponex Corporation - acquired 11/10/88.
(h) Total Debt reflects Bank and Subordinated Debt only.

(i) Safeway (UK) - Stockholders Equity at FYE 12/31/88 per Bank Loan Agreement

BWIP - Stockholders Equity at FYE 12/31/88.

Nu-kote - Estimated Stockholders Equity at FYE 3/31/89 per Bank Loan Agreement. Reflects non-recurring charges of $6.9MM, for plant closing in Canada and other restructuring. Charges taken in fiscal 1989 third quarter.

O.M. Scott - Stockholders Equity at FYE 9/30/88 per Bank Loan Agreement

Uniroyal Goodrich Tire Co. - Total Partnership Net Worth and Senior Preferred Interest at 11/30/88.

Pilliod - Stockholders Equity per FYE 4/30/88 financial statement.

Arnold Foods - Stockholders Equity per 11/8/86 financial statement.

[illegible] - Stockholders Equity at FYE 12/31/88.

Harris Graphics - Stockholders Equity per FYE 6/30/85 financial statement.

WGM Safety - Stockholders Equity per FYE 12/31/85 financial statement.

Stanley Interiors - Estimated Stockholders Equity at time of sale.

Prepared January 1989

Mr. **Coyne**. Thank you, Mr. Rice.

We had one more witness that I am told is here. Mr. Poterba.

STATEMENT OF JAMES M. POTERBA, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, AND RESEARCH ASSOCIATE OF THE NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. **Poterba**. Thank you, Mr. Chairman. My name is James Poterba. I am a professor of economics at MIT, and a research associate at the National Bureau of Economic Research.

My comments this afternoon will address three aspects of the various proposals before the committee. First, I will discuss the importance of the cost of capital as an aspect of American business policy and explain why it is a fundamental summary measure of what these policies will do to American corporations.

Secondly, I will explain why a particular set of the proposals, notably those which restrict the tax deductibility of interest, will have the effect of raising the cost of capital, while those which provide some type of deductibility for dividend payments will have the effect of lowering that cost, and therefore improving the competitive position of U.S. firms. Finally, I will explain how this analysis applies works even when the proposals are considered in a revenue neutral context.

Let me begin with the question of why the cost of capital is, in fact, a very vital summary statistic of American business practice.

The cost of capital is the cost of acquiring capital assets to use in business operations. We know that as the cost of capital rises, firms will choose to invest less, and in particular, very long-horizon projects will be sensitive to the cost of capital.

We also know that many of our major international competitors have firms whose costs of capital are below those in the United States. Some studies suggest the Japanese cost of capital is only two-thirds of that of the United States. This conveys a substantial cost advantage on our international competitors.

If the cost of capital in the United States rises, that inexorably will lead to an increase in the price of U.S. goods, to a less favorable U.S. position abroad, and actually to less investment by U.S. firms. That is why, I think, it is very important to consider how these various proposals will affect the cost of capital. Those proposals that raise the cost of capital by restricting interest deductions seem much less attractive on this criteria than alternative proposals which would have the effect of lowering the cost of capital by reducing the tax burden on dividends or providing a corporate tax subsidy for capital in use.

I should note, of course, that it may come as no surprise that proposals which would raise corporate tax revenues by disallowing interest deductions will discourage investment and raise the cost of capital.

But the same thing is true even if the proposal that you consider is revenue neutral, so that an interest deduction restriction is coupled with a corporate tax rate reduction. The basic reason for that involves the difference between the future investments that firms undertake—so-called new capital—and the existing assets that are in place. When we raise the cost of borrowing by restricting interest deduction, it becomes more expensive to undertake new investment projects. On the other hand, when we lower the corporate income tax rate to offset that, that primarily conveys a windfall on the existing assets that are in place—the so-called old capital—and that reiterates exactly the same point that we made in the 1986 Tax Act when we made it more expensive to undertake new investment projects by taking away investment incentives and at the same time lowered the tax burden on the assets already in place.

Now even the most ardent supply-sider will not contend that by lowering the tax burdens on existing assets, we can produce any more of those assets. We know that that investment simply cannot take place, and therefore, it seems inappropriate to tilt tax policy in a direction which provides incentives to the existing assets and raises their return while discouraging investment in new and other productive assets. So I would urge the committee against even the revenue neutral options which have the effect of raising the cost of capital.

Nonetheless, there are some options before the committee which actually would have the effect of both strengthening the U.S. competitive position and removing the substantial tax incentives for corporate borrowing.

Those proposals fall into the broad classes. The first are proposals which would allow for dividend deductibility at the corporate level, or adopt some kind of explicit integration of the corporate and the personal income taxes. Those plans would likely have the effect of lowering the cost of equity capital, although at the same time, encouraging firms to pay something in the way of dividends beyond the current levels, because they would essentially reduce the tax burden on dividend distributions.

A second class of plans—one which is proposed in a paper on overconsumption authored by George Hatsopoulos and Paul Krugman and myself, which the committee heard about in its recent hearings on savings in the U.S. economy—suggest that we might define a capital subsidy or capital deduction for firms. We would allow a deduction equal to a given fraction of total firm capitalization, which might be measured by adding together book debt and book equity.

What the capital reduction would essentially do is to recognize that capital, just as labor and materials, is an input to production. It would allow firms to take some account of that in making up their end of year accounts for tax purposes.

The appeal of the capital deduction, as opposed to the dividend payment credit, is that it would not encourage firms to distribute dividends. Our results in the overconsumption study suggests that when firms distribute a higher fraction of dividends the national saving rate declines, since corporations tend to retain earnings and save at a relatively high rate while shareholders, tend to consume out of cash receipts to a higher degree.

If we wish to both lower the cost of capital and encourage international competitiveness, while at the same time trying to raise the national saving rate—something which on other grounds, I think, is an important and pressing national priority, the appropriate set of policy measures to use are those which encourage equity finance, perhaps in a revenue neutral way, without providing substantial increases in the incentive for dividend payments.

Thank you very much.

[The statement of Mr. Poterba follows:]

THE COST OF CAPITAL CONSEQUENCES OF CURBING CORPORATE BORROWING

James M. Poterba

My name is James Poterba. I am a Professor of Economics at the Massachusetts Institute of Technology and a Research Associate at the National Bureau of Economic Research. I am pleased to have this opportunity to testify before this distinguished committee on the tax aspects of mergers and acquisitions.

My comments this afternoon will focus on how proposed modifications to the tax treatment of debt and equity affect the cost of capital facing American firms. Some of the tax options for slowing the leveraging of U.S. corporations have the undesirable effect of increasing capital costs and making U.S. firms less competitive in the world marketplace, while others could both reduce corporate leverage and improve our competitive stature.

I will concentrate on three points. First, the cost of capital is an important influence on the competitive position of U.S. firms. High capital costs deter managers from undertaking long-term investments and slow the growth rate of living standards. Tax policy is one of the government's most direct instruments for influencing the cost of capital, and it is therfore imperative to consider the impact of various proposals on capital costs.

Second, plans to equalize the tax treatment of debt and equity by restricting interest deductibility raise the cost of capital, while proposals to reduce the tax burden on equity reduce it. This remains true even when changes in debt or equity tax burdens are paired with revenue-neutral changes in the corporate tax rate.

Third, allowing general deduction for both debt and equity capital or deductibility of all distributions to corporate claimants (whether debt-holders or stockholders) would reduce the incentive for corporate borrowing without adversely affecting the cost of capital. Either plan could be drafted to minimize the windfall gains and losses for exisitng corporations and to concentrate on changing the incentives for new investment.

1. The Importance of the Cost of Capital

Just as a firm which must pay higher wages than its competitors will face a disadvantage in the marketplace, a firm which is required to pay more for the capital it needs will be forced to charge a higher price its products. The cost of capital is also a key determinant of the amount a firm invests. If the firm's after-tax cost of obtaining funds from credit markets is relatively low, the firm's managers will find it profitable to invest in projects that involve current costs but yield increased cash flows in future years. Managers facing a high cost of capital will forego such projects, since the cost of making interest or dividend payments to the investors who supply capital will exceed the project's return.

It is often suggested that a high cost of capital inhibits American investment and encourages myopia among American managers. Comparisons of the cost of capital in the United States and Japan, for example, often reveal a substantial cost-of-capital advantage for Japanese firms (8.4% per year, versus 12.9% per year for the United States, in one recent study)[1]. To illustrate the effect of this differential, an American manager would be willing to invest $.37 in return for a dollar six years from now, compared with $.66 for his Japanese counterpart. This may in part explain the common view that Japanese managers take a longer view than American executives. Research and development projects, with prospective returns one or even two decades away, are especially vulnerable to increases in the cost of capital.

The general conclusion that high rates of investment are associated with higher rates of growth in living standards emerges clearly in a comparison of nations (see Figure 1). This underscores the need to avoid arbitrary increases in the cost of capital which may discourage productive investments.

2. Current Proposals and the Cost of Capital

One of the central determinants of a firm's cost of capital is its real after-tax cost of funds. This is the average of a firm's costs of debt and equity, weighted by the relative amounts of debt and equity used to finance new investments. Many current proposals for limiting interest deductibility would increase the after-tax cost of funds facing U.S. firms and thereby raise the cost of capital. Plans to completely repeal interest deductibility, to restrict it to debt yielding below a threshold rate, or to limit it to debt accounting for less than a specified fraction of a corporation's net worth are in this category.

To illustrate the cost of capital consequences of tax changes, consider a firm with equal shares of debt and equity in its capital structure. Its bondholders demand a 10% nominal return (assume a four percent inflation rate) and equity-holders demand 18%. The real after-tax cost of equity, which sub- tracts inflation from the investors' required return, is therefore 14% (= 18% - 4%). With a 34% corporate tax rate and full deductibility of interest, the real after-tax cost of debt is only 2.6% (= (1-.34)*10% - 4%). The firm's average cost of funds is therefore 8.3%. If only half of the firm's interest payments were deductible, the real after-tax cost of funds would climb to 9.2%. Eliminating deductibility would raise the cost of funds to 10%. The cost of capital would increase by even more if the firm was initially financed primarily with debt.

Restricting interest deductibility would increase corporate tax revenues. The adverse effect on investment incentives may therefore seem unsurprising. Even if deductibility restrictions were coupled with a reduction in corporate tax rates, however, the reform would still discourage investment. Limitations on interest deductibility, particularly when phased-in so as to apply only to new issues of debt, raise the cost of funds for new investments. Reductions in the corporate tax rate partially offset this effect but they also provide a windfall to the owners of "old capital."

One kind of investment that we know tax policy cannot encourage is investment in existing assets. Yet recent tax reforms have been generous to the owners of these assets. The combination of rate reduction and elimination of investment incentives in the 1986 Tax Reform Act reduced taxes on "old capital" by an estimated $68 billion between 1987 and 1991, while raising tax burdens on new capital by $184 billion.[1] Policies to restrict corporate leverage should be designed to avoid still further windfalls.

3. Options for Reducing Leverage without Raising the Cost of Capital

It is possible to design schemes to reduce incentives for corporate borrowing without increasing the cost of capital. The critical ingredients of such plans are (i) providing a subsidy for equity finance to partly offset the increased cost of debt associated with reduced deductibility, and (ii) target-ting such subsidies on new security issues to avoid generating windfalls for existing capital. Two plans satisfying these conditions are discussed below.

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[1] G.N. Hatsopoulos and S.H. Brooks, "The Gap in the Cost of Capital," in R. Landau and D. Jorgenson, eds., Technology and Economic Policy (Cambridge: Ballinger Publishers, 1986).

A General Deduction for Capital

One option for slowing the growth of leverage was proposed in Overconsumption: The Challenge to U.S. Economic Policy, a report which I co-authored with George N. Hatsopoulos of Thermo-Electron Corporation and Paul Krugman of MIT. We suggest replacing the current deduction of interest on debt with a general deduction for capital, set at some percentage of a firm's overall capitalization. The essence of this proposal is that capital, whether obtained by borrowing or issuing equity, should be recognized as an input to production just like labor or materials. Firms should therefore be allowed to recognize some expense for capital inputs.

At the end of 1988, the Federal Reserve Board estimated that the market value of debt for nonfinancial corporations was .70 times the market value of their outstanding equity. Debt therefore accounted for 41% of their total capitalization. Assuming an average yield on corporate debt of 11%, current interest deductibility rules could be replaced with a 4.5% per year deduction for capital at no revenue cost.

This plan could be phased-in either by allowing a gradual transition in which interest deductibility would be replaced by capital deductibility, or by allowing a capital deduction only on net additions to corporate capitalization. The first option would provide a windfall to existing low-debt firms while burdening those firms with higher than average debt equity ratios. The second would eliminate the incentive for recapitalizing existing firms with debt rather than equity, but it might encourage existing low-debt firms to attempt to replace non-deductible equity in their capital structures with deductible equity.

Dividend Deductibility

A second method for equalizing the costs of debt and equity finance without raising the cost of capital involves granting some deductibility to corporate dividend payments. This could be done either by making dividend distributions deductible from the corporate income tax, or by integrating the personal and corporate income taxes as in many European tax systems. Both proposals would lower the after-tax cost of equity to corporations.

Universal dividend deductibility would be quite costly to the Treasury, and much of its benefit accrues to "old capital." At current corporate rates, the annual revenue loss from full dividend deductibility would exceed $30 billion. Feasible plans therefore allow either partial deductibility for all dividends, or restrict deductibility to dividends on shares issued after the plan was enacted. The second option is much more attractive, since most dividends that will be paid in the next few years are the result of past investments, not investments that will be made after the reform plan takes effect. Plans to allow dividend relief on new equity, including the ALI proposal which has been discussed before this committee, would avoid providing such a windfall.

Although both a deduction for capital and a deduction for dividends would avoid increasing the cost of capital and thereby preserve investment incentives, a deduction for dividends would encourage corporate payout at the expense of retained earnings. One of the conclusions of the Overconsumption study is that stockholders are more likely to spend what a corporation earns on their behalf if the earnings are distributed as dividends, rather than reinvested in the firm. Thus plans for phasing in a dividend deduction might adversely affect the long-run private saving rate.

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[2] Lawrence H. Summers, "A Fair Tax Act that's Bad for Business," Harvard Business Review, March-April 1987.

There are other differences in the incentives provided by the capital deduction and the dividend deduction, but these are minor relative to the differences between both of these plans and proposals to equalize the costs of debt and equity by raising the tax burden on corporate borrowing. Eliminating or restricting interest deductibility would raise the cost of capital to American firms, increasing their costs vis-a-vis international competitors. Higher capital costs would discourage productive investments in plant and equipment and ultimately slow the growth of American living standards. It is therefore imperative to avoid policies which would inadvertently raise the cost of capital.

Mr. COYNE. Thank you, Mr. Poterba. I want to thank the panel for your testimony and for being here today, and we will look with great favor on your testimony as we deliberate the proposals that have been made relative to the subject of takeovers. Thank you very much.

[Whereupon, at 12:49 p.m., the committee was adjourned, to reconvene at 10 a.m., Wednesday, May 17, 1989.]

TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

WEDNESDAY, MAY 17, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 10:04 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

Today, the committee continues hearings regarding the tax and economic policy aspects of leveraged buyouts and transactions which increase levels of corporate debt. During the 6 prior days of public hearings on this topic, the members of the committee have gained a tremendous amount of knowledge about these complex issues.

The committee is currently at the stage of reviewing specific proposals for legislative change as set forth in the committee's press release, dated April 12, 1989. I can't predict whether the committee will decide to act on these issues in the near future, but I hope that the testimony that we receive today will assist the members in deliberating upon these important economic and tax policy matters.

Our first panel today consists of T. Boone Pickens, appearing on behalf of the United Shareholders Association; Margaret Cox Sullivan, representing the Stockholders of America; and Hardwick Simmons, appearing on behalf of the Securities Industry Association.

Welcome, Mr. Pickens. The committee is ready to take your testimony. The Chair would also like to observe that if the written statement is of great length, the entire statement will be put in the record, and if the witnesses would care to summarize, we leave that up to you.

Mr. Pickens.

STATEMENT OF T. BOONE PICKENS, CHAIRMAN, UNITED SHAREHOLDERS ASSOCIATION, AND GENERAL PARTNER, MESA LIMITED PARTNERSHIP, AMARILLO, TX

Mr. Pickens. Mr. Chairman and members of the committee, thank you for inviting me to testify today. I am general partner of Mesa Limited Partnership, based in Amarillo, TX, and chairman of the United Shareholders Association, a grassroots advocacy organization based here in Washington, and I am appearing today on behalf of the United Shareholders Association.

With your permission, Mr. Chairman, I will summarize my written testimony, which I have submitted for the record. The issues that you are addressing today are extremely complex and affect the lives of millions of Americans. We applaud you for conducting a wide-reaching, thorough study of these issues.

USA has more than 58,000 members in 31 local chapters across the United States. Our members are individual shareholders who share a commitment to public and corporate policies aimed at promoting shareholders' rights and management accountability.

We see these principles as, essentially, elements of a more competitive and prosperous American economy. I am not an economist, but the evidence is clear that corporate restructuring is making American corporations more efficient, competitive and valuable.

A bibliography of the most prominent economic research in the field is attached to my testimony and I request it be made part of the hearing record.

Rather than parroting this economic evidence, I would like to give you a perspective on corporate restructuring from the shareholders' point of view, and my own experiences.

There are two points I want to stress today. One, Congress should not attempt to interfere with what has been a smoothly functioning free market process for mergers and acquisitions; and two, Congress should not establish a distinction between so-called hostile and friendly transactions.

There is a concern in the Congress about the levels of debt created in certain corporate restructuring transactions. There's also a concern that shareholders are not receiving maximum value for their shares in LBO's. These two concerns create a policy conflict. In order to give shareholders maximum value, creative financing arrangements have been developed, and some Members of Congress are pursuing legislative proposals in an effort to establish what they believe is a proper balance.

They assume that legislation can determine the correct level of debt in a transaction, but the only way to strike a proper balance is through the functioning of a free market. It would be impossible for Congress to legislate a system which can choose between good and bad transactions better than free market forces.

The market penalizes those who invest in over-leveraged transactions and rewards those who invest wisely. If Congress wants to reduce the levels of debt used in corporate restructuring, it should remove the tax bias against equity financing by reducing the double taxation of dividends.

With this approach, the market would determine the level of debt used in transactions based on underlying risks, rather than tax questions. This would also encourage higher dividend payments and more rational use of corporate earnings.

The second point I would like to emphasize from my written testimony is that Congress should resist any proposal to tax so-called hostile transactions more heavily than so-called friendly transactions. I see a great peril in encouraging management-approved transactions over those opposed by incumbent managers.

Who is it that defines whether an offer is hostile? Under the option being considered by the committee, it would be up to the incumbent managers to decide whether or not an offer is hostile.

That would give tremendous authority to people with direct conflict of interests.

So-called hostile takeovers are unfriendly only in the eyes of the incumbent managers. I have said I would no longer be involved in hostile acquisitions, but I haven't heard from a shareholder yet who thought that a premium offer for their stock was a hostile act. And after all, shareholders are the owners of our public corporations.

The opportunity for takeovers and LBO's is created by undervalued corporate assets trading in a public marketplace. The answer to the problem of undervalued companies is to restore accountability of corporate managers to their shareholders. If management were truly accountable, it would respond with increased focus on its primary mission, which is maximizing value for the company's owners.

USA has made several proposals for reforming corporate governance to accomplish these objectives. Because these reforms are within the jurisdiction of other congressional committees, I will not elaborate on them here. United Shareholders Association would be willing, however, to answer any questions the committee may have on these issues.

Again, I want to thank the committee for inviting the views of United Shareholders Association on this extremely important subject. We stand ready to assist the committee in any way possible during its consideration of these important issues.

Thank you.

[The statement of Mr. Pickens follows:]

STATEMENT OF T. BOONE PICKENS, CHAIRMAN, UNITED SHAREHOLDERS ASSOCIATION

Introduction

Mr. Chairman and members of the committee, thank you for inviting me to testify today. My name is T. Boone Pickens. I am general partner of Mesa Limited Partnership, based in Amarillo, Texas, and chairman of the United Shareholders Association, a national grassroots shareholder rights advocacy organization based in Washington, D.C. I am appearing today on behalf of USA.

The issues you are addressing today are extremely complex and effect the lives of millions of Americans. We applaud you for conducting a wide-reaching and thorough study of these issues.

USA has more than 58,000 members and 31 local chapters across the United States. Our members are individual shareholders who share a commitment to public and corporate policies aimed at promoting shareholder rights and management accountability as essential elements of a more competitive and prosperous American economy.

I am not an economist, but any objective observer would conclude that the economic evidence is overwhelming that corporate restructuring -- which includes leveraged buyouts, takeovers and other merger and acquisition activity -- is helping American corporations become more productive, profitable and valuable. I have attached a bibliography of the most prominent studies making up this economic evidence.

A Shareholder's Perspective

In these hearings, you've already heard from most of the recognized economic experts. Rather than parroting what I've read of their work, I'd like to give you a perspective on corporate restructuring from the shareholders' point of view and my own experience.

I've probably followed these issues as closely as anyone, for as long as anyone. Looking back over the years, it seems that in this area Congress has had great difficulty maintaining a focus. First, there was the initial wave of unsolicited corporate takeover attempts in the early 1980s. This generated political pressure from corporate America's managers, who realized that takeovers were a major threat to their insular positions.

Then there was the insider trading scandal. At first, a number of people in Congress thought that the way to clean up insider trading was to stop corporate restructuring. But it was quickly realized that you don't close the banks to stop Jesse James.

In October 1987 the stock market crashed. Again, it served the interests of corporate management to try to convince Congress that takeovers were responsible.

Now, the focus has shifted again because of leveraged buyouts. LBOs have been occurring for several years. There were many abuses in the early 1980s. But LBOs didn't become a major question of public policy until a large consumer products company -- RJR Nabisco -- was involved in a transaction.

Conflicts of Interest

It is true that LBOs present tremendous potential for abuse. LBOs involve a blatant conflict of interest for managers because they have a legal responsibility to get the highest price possible for shareholders, while at the same time they have a personal interest in paying the lowest price necessary to obtain control.

Managers wear two hats in an LBO. There were abuses early on because the natural inclination of someone in that position is to wear the buyer's hat instead of the seller's hat. But the legal system and the functioning of a free market have alleviated these abuses.

Actually, the RJR-Nabisco deal demonstrates that the system is working. The first offer for the company from the incumbent management group was $75 dollars per share, or $17 billion dollars, which was widely considered inadequate.

But the legal system forced the board of directors to open a competitive bidding process for control of the company. In the end, the company was sold for $25 billion, $8 billion more than the original management offer.

The RJR shareholders were well served by a legal framework that recognizes that shareholders' interests must come before those of management, and a free market which made financing available for competitive offers.

There is, I recognize, a potential contradiction in policy here. On one hand, we want a system that ensures that shareholders receive the highest possible price for their stock. On the other hand, some in Congress are concerned about excessive corporate debt. While the auction process and innovative financing techniques are allowing shareholders to receive the highest possible price, LBOs and other restructuring transactions may leave some companies with very thin margins for error, particularly in bad economic times.

"Good" and "Bad" Transactions

But the only way to strike the proper balance is through the functioning of a free market. In a free market, some deals will be good and some bad. Those who invest in bad deals are penalized by the market. At this point, the good seem to outweigh the bad, or there wouldn't be an active marketplace.

Congress cannot possibly legislate a system which can delineate between good and bad transactions. The market performs this function very efficiently on its own. Congress should tread very carefully in attempting to second-guess the markets. The consequences of your actions could reach far beyond your intent.

Remove Tax Bias Against Equity

If Congress wants to reduce the level of debt used in mergers and acquisitions, or corporate financing in general, it should remove the tax bias against equity financing. The current system penalizes equity relative to debt through the so-called double taxation of dividends.

Given the deductibility of interest expenses, the tax treatment of equity creates a strong lure toward debt. But I urge the committee not to impose new taxes on debt. This would put Americans at a distinct disadvantage to foreign investors, who would not be subject to the new taxes, as well as penalize corporate transactions which are leading to new levels of productivity and efficiency.

Committee's Options

Several of the options under review by the committee would move us in the direction of more rational taxation of equity. We favor giving corporations a deduction for their dividend payments to shareholders. This would encourage higher dividend payments and more rational use of retained corporate earnings.

At the same time, some of the options under discussion would harm shareholders and the economy by penalizing debt creation through increased or new taxes. One proposal would deny an interest deduction for debt incurred to purchase stock if an offer is opposed by a majority of the independent members of the incumbent board of directors.

I see great peril in encouraging management-approved transactions and discouraging those opposed by incumbent management. This would leave vital decisions over the allocation of corporate resources in the hands of people with a tremendous conflict of interest.

Hostile v. Friendly Transactions

This committee should recognize that so-called hostile takeovers are unfriendly only in the eyes of the incumbent managers.

From the owners' point of view, the shareholders, these offers are friendly as they invariably result in substantial premiums. From this perspective, management is the hostile party when it attempts to defeat premium offers to shareholders.

Whether an offer is hostile or friendly is strictly a question of one's perspective.

So-called friendly transactions, in fact, are the ones that often are "bad" in terms of their economic viability. For example, friendly deals often involve conglomerate acquisitions, where management is "diversifying" by buying a company that has no relationship to its core business.

Again, while I'm not here to parrot the work of qualified economists, I would note that a study by the Securities and Exchange Commission recently showed that these conglomerate acquisitions often depress stock prices, creating the conditions for a hostile offer down the road.

The bottom line is that classifying a deal as hostile or friendly is an arbitrary and discriminatory way of separating good acquisitions from bad, and does not serve any public policy goal other than giving more autonomy to entrenched managers.

Need For Accountability

The opportunity for takeovers and LBOs is created by undervalued corporate assets trading in a public marketplace. If the stock price of a corporation fully reflects the value of its assets, it won't be vulnerable to a buyout because nobody would be capable of making a profit on the transaction. It really is that simple.

The answer to the problem of undervalued corporations is to restore accountability of corporate managers to their shareholders. If true accountability were introduced to the structure of our public corporations through reforms in the proxy voting system, you wouldn't see as many takeovers. Shareholders would be able to replace mediocre management, and managers would respond to that possibility with increased focus on their primary mission -- maximizing value for the companies' owners.

At USA, we've made proposals for reforming corporate governance to accomplish these objectives. Since these reforms are outside the purview of this committee, I will not elaborate on them here. USA would be willing, however, to answer any questions the committee may have on these issues.

Conclusion

The evidence is clear that corporate restructuring, through various forms of merger and acquisition activity, is making American corporations more efficient, competitive and valuable.

Although the management-led LBO presents opportunities for severe conflicts of interest between managers and shareholders, the legal system and the forces of a free market are alleviating much of this abuse.

Concerns in Congress about the levels of debt created in certain corporate restructuring transactions are best left to the market to work out. An efficiently functioning free market is the best judge of what is a "good" or "bad" transaction.

Any changes in tax policy toward mergers and acquisitions should seek a balance between debt and equity by encouraging equity creation rather than penalizing debt. Taking steps to reduce the double taxation of dividends would result in a more rational allocation of available capital so that investment decisions are made on the basis of underlying risk rather than tax considerations. It will also result in higher distribution of corporate earnings to shareholders, with highly beneficial consequences for continued economic growth.

Congress should reject any proposal to tax "hostile" transactions more heavily than "friendly" transactions. This would give tremendous autonomy to incumbent managers to pursue strategies that destroy shareholder value and would ultimately harm the competitiveness of American corporations.

We thank the committee for inviting the views of the United Shareholders Association on this extremely important subject. We stand ready to assist the committee's consideration of these issues in any way possible.

Chairman ROSTENKOWSKI. Thank you, Mr. Pickens.
Ms. Sullivan.

STATEMENT OF MARGARET COX SULLIVAN, PRESIDENT, STOCKHOLDERS OF AMERICA, INC.

Ms. SULLIVAN. Thank you, Mr. Chairman and members of the committee. Not only do I want to thank you for the invitation to appear again before this distinguished committee, but I also want to express my admiration to you for your willingness to tackle the issues before us today. They are very complex.

As a nation, we are facing a crisis.

Chairman ROSTENKOWSKI. Ms. Sullivan, could you pull that microphone a little closer, please?

Ms. SULLIVAN. Sure. I thought you could hear me in the stadium. Shall I start over? Want me to? OK.

Not only do I want to thank you—can you hear that now?

Chairman ROSTENKOWSKI. Yes.

Ms. SULLIVAN. OK.

Not only do I want to thank you for the invitation to appear again before this distinguished committee, but I also want to express my admiration to you for your willingness to tackle the issues before us today. They are very complex.

As a nation, we are facing a crisis. We have a troubled economy, the basic cause is debt. The issues we are here to discuss will not be entirely solved by tax policy, but it is a valiant start.

Of course, my name is Margaret Cox Sullivan and I am president of Stockholders of America, the 17-year-old national, nonprofit, nonpartisan organization, representing the interests of American stockholders, the individuals always known as the "little guy," often called the "backbone of our capitalistic system, free enterprise," and a vital ingredient of our capitalistic system of our capital markets.

While their ranks are lessening, their important role has not. Our markets will not function in a stable, orderly way without the millions of differing, daily, individual, diversified market transactions. They are usually long-term investors. They take an interest in their companies, interested in the company's long-term plans. Their eyes are on the long run. Their vision is for the future.

The company's growth means their growth, and that adds up to the growth of the national economy. The issues of takeovers, LBO's, junk bonds, the issues before us today have brought on a profound change. To quote Felix Rohayton, things are getting badly out of hand. Another knowledgeable American, Judge Stanley Sporkin, who for years directed the Enforcement Division of the SEC, said, these takeovers are the busting up of American business. Something has to be done.

A recent study by Solomon Brothers of the trend culminating in the $25 billion buyout of RJR-Nabisco concludes this: All but a few of the largest corporations may be candidates for an LBO. In other words, almost no corporation can be sure that it won't be taken over by an investment group using funds generated primarily through long-term, high-risk borrowing—junk bonds.

The Solomon study shows that apart from the RJR-Nabisco deal, there were 28 LBO's of more than $500 million each between 1985 and 1988, totaling $65 billion in value, against which only $25 billion in junk bonds were written.

To substantiate my earlier statement that we do face a crisis of debt, the well-known Henry Kaufman quotes some very, very sound figures. Over the past 5 years, the debt of nonfinancial U.S. corporations has gone up by $840 billion, and the value of corporate equity has diminished by almost $300 billion. It must be noted that in Japan and Europe, corporate debt is going down and equity is going up.

Our ratio of equity and debt is completely out of balance by any standard economic yardstick. This can be remedied by a change, a change in the tax treatment of corporate debt and equity, and we suggest three ways.

One, the deduction for the interest payments on junk bonds used for the purpose of financing hostile takeovers should be denied. Junk bonds are defined in option three of your committee's press release.

Two, stockholders should be given equal credit for the corporate rate applied to the dividend. That would eliminate the double taxation on dividends, and that figure would appear on the 1099 form the corporation must send annually to each stockholder. This would be visible, concrete evidence that the stockholder and owner of the enterprise is paying taxes only once.

Three, establish a sliding scale formula for the tax treatment of capital gains. This is not a new idea and it is not my intent to propose a new idea which would politically or administratively complicate the present system. But we would like the committee to reexamine and redevelop an old idea, an idea of this committee's predecessors in the 1934 act. Then, as now, the committee was vitally concerned about the economy.

I would like to quote from an article written by former Supreme Court Associate Justice Arthur Goldberg a year or so ago.

> The need for public airing of the takeover game is even more evident than in the thirties. The securities markets have undergone profound changes. The growth and impact of the market on our economy are infinitely greater than during the Depression. And abuses, unless corrected, can have an even more far-reaching affect. Credibility is the touchstone of the capital markets, as it is of our political system. If the confidence of investors is impaired, a debacle is not impossible.

I would not presume to make the judgment on the numbers in this sliding scale. That must be the determination of this committee. The 1934 act was to tax capital gains on a scale graduating downward to a 10-year holding period.

My suggestion would be that the differential tax treatment be established again at what it was before 1986—20 percent for assets held for over a year. Then incorporate a downward slide until the tax reaches a 5-percent level for assets held for 15 years or over. Collectibles would not be included.

We want long-term equity investments to be attractive. We need productive working capital if American companies are to regain the number one position around the world, and tax incentives are vital. There is also historic proof that every time the capital gains tax was lowered, more revenues in the Treasury were realized.

There were more initial public offerings. The number of these IPO's started a downward trend in 1987 and slowed down appreciably in 1988. SEC figures reveal this.

The three elements which we have suggested here today—and support—would create a positive impact on the more orderly functioning of the market. It will be an incentive to bring the individual equity investor back into the market. One just has to read the financial press to realize that individual investments have fallen off. Individual savings go hand in hand.

It is estimated that 70 percent of the trading is now done by the institutions. Again, I would like to point out that the stockholders are not the so-called rich. They are not in the $530 million a year income class. I have these demographics right there, but I won't bore you people with the numbers. You're going to hear so many of them today.

But I will go right into a closing remark that I really want to do because I want to quote from a Time magazine article of December 1985, from an interview with Mr. Felix Rohayton. The article states,

> Rohayton fears that it will take a crisis to end dangerous excesses of the merger fever.

Then he prophesied,

> The way we are going will destroy all of us in this business. Someday, there is going to be a major recession, major scandals. All of us may be sitting in front of congressional committees trying to explain what we are doing.

Thank you again.

[The statement of Ms. Sullivan follows:]

Statement Before
The Committee on Ways and Means
By
Margaret Cox Sullivan
President
Stockholders of America, Inc.
May 17, 1989

Mr. Chairman and Members of the Committee:

Not only do I want to thank you for the invitation to appear again before this distinguished Committee, but I also want to express my admiration to you for your willingness to tackle the issues before us today. They are very complex. As a Nation we are facing a crisis -- we have a troubled economy. The basic cause is debt -- we are debt ridden on all levels of our society. The issues we are here to discuss today will not be entirely solved by tax policy -- but it is a valiant start.

My name is Margaret Cox Sullivan and I am President of Stockholders of America, the 17 year old organization representing the interests of American stockholders, the individuals always known as "the little guys" -- often called the "backbone" of our capitalistic system, free enterprise, and a vital ingredient of our capital markets. While their ranks are lessening, their important role has not. The individual investor is needed now more than ever. Our markets will not function in a stable, orderly way without the millions of differing daily individual diversified market transactions. This is needed for liquidity, for a true auction market, and a more realistic value of stocks. They are usually long term investors. Their pattern of investing is different from the large financial institutions. They take an interest in "their companies", interested in the companies' long term plans -- the new products, new ways of production, new technologies, new plans for expansion and growth. Their eyes are on the long run. Their vision is for the future. The companies' growth means their growth and that adds up to the growth of the National economy.

The issues of takeovers, LBOs, junk bonds -- the issues before us today have brought on a profound change. To quote Felix Rohatyn "things are getting badly out of hand". Another knowledgeable American Judge Stanley Sporkin who for years directed the enforcement division of SEC said these takeovers are "the busting up of American business".

Something has to be done.

A recent study made by Solomon Brothers of the trend culminating in the $25.1 billion buyout of RJR/Nabisco concludes:"All but a few of the largest (American) corporations may be candidates for a LBO". In other words almost no corporation can be sure that it won't be taken over by an investor group using funds generated primarily through long-term high-risk borrowing junk bonds. The Solomon Brothers study shows that apart from the RJR/Nabisco deal there were 28 LBOs of more than $500 million each between 1985 and 1988 totaling $65 billion in value, against which $25 billion in junk bonds were written.

To substantiate my earlier statement that we do face a crisis of debt -- the well known Henry Kaufman quotes some very sound figures. Over the past five years, the debt of nonfinancial U.S. corporations has gone up by $840 billion and the value of corporate equity has diminished by almost $300 billion. It must be noted too that in Japan and Europe corporate debt is going down and equity is going up.

Our ratio of equity and debt is completely out of balance by an standard economic yardstick. This can be remedied by a change in the tax treatment of corporate debt and equity . We suggest three ways for your consideration.

1. The deduction for the interest payments on junk bonds used for the purpose of financing hostile takeovers should be denied. Junk bonds are defined in option three of the Committee's Press Release. This change in the tax treatment would bring in added revenues to the Treasury. It would help restore investor confidence in the system.

2. The double taxation on dividends should be eliminated. This is unfair. In all our surveys through the years this was the number one concern of stockholders. It can be easily remedied. Stockholders would be given credit equal to the corporate rate applied to the dividend. This figure would appear on the 1099 form the corporation must send annually to each stockholder. This would be visible concrete evidence that the stockholder, an owner of the enterprise, is paying taxes only once. It would be a longed for incentive and I am confident it would stimulate equity investment.

3. Establish a sliding scale formula for the tax treatment of capital gains. This is not a new idea. It is not my intent to propose a new idea that will politically or administratively complicate the present system -- but would like to have the Committee re-examine and re-develop an old idea -- an idea of this Committee's predecessors in the 1934 Act. Then as now the Committee was viatally concerned about the economy.

I would like to quote from an article written by former Supreme Court Associate Justice Arthur Goldberg a year or so ago "The need for public airing of the takeover game is even more evident than in the '30s. The securities markets have undergone profound changes. The growth and impact of the market on our economy are infinitely greater than during the depression, and abuses, unless corrected, can have an even more far reaching effect. Credibility is the touchstone of our capital markets, as it is of our political system. If the confidence of investors is impaired, a debacle is not impossible".

I would not presume to make the judgment on the numbers in the sliding scale. That must be the determination of this Committee. The 1934 Act was to tax capital gains on a scale graduating downward to a ten year holding period. My suggestion would be that the differential tax treatment be established again at what it was before 1986 -- 20% for assets held for over a year, then incorporate a downward slide until the tax reaches a 5% level for assets held 15 years or over. Collectibles would not be included.

We want long term equity investments to be attractive -- we need productive working capital if American companies are to regain the number one position around the world. Tax incentives are vital. There is also historic proof that every time the capital gains tax was lowered more revenues in the Treasury were realized. There were more initial public offerings. The number of these IPOs started a downward trend in '87 and slowed down appreciably in '88. SEC figures reveal this. The three elements which we have suggested here today and support would create a positive impact on the more orderly functioning of the market. It will be an incentive to bring the individual equity investor back into the market. One just has to read the financial press to realize the individual investments have fallen off. Individual savings go hand in hand. It is estimated that 70% of the trading is now done by institutions.

Again I would like to point out that stockholders are not the so-called rich. They are not in the 535 million dollar a year income class. The last demographic chart shows:

The number is 47 million
Equal number of men stockholders and women stockholders
The median age is 44 years. Younger than before
The median portfolio is now $6,200
49.5% have an annual household income in the $25,000 to $50,000 range
26.2% in the $50,000 and over range
4.5% in the $100,000 and over range
3.6% in the $100,000 to $149,999 range
.4% in the $150,000 to $249,000 range
.5 in the above $250,000 range

In closing I would like to quote from a Time Magazine article of December written from an interview with Mr. Felix Rohatyn. The article states "Rohatyn fears that it will take a crisis to end dangerous excesses of the merger fever". Then he prophesied "The way we are going will destroy all of us in this business. Someday there is going to be a major recession, major scandals. All of us may be sitting in front of congressional committees trying to explain what we were doing".

Thank you again.

Chairman ROSTENKOWSKI. Thank you, Ms. Sullivan.
Mr. Simmons.

STATEMENT OF HARDWICK SIMMONS, CHAIRMAN, BOARD OF DIRECTORS, SECURITIES INDUSTRY ASSOCIATION AND VICE CHAIRMAN OF THE BOARD, SHEARSON LEHMAN HUTTON, INC., NEW YORK, NY

Mr. SIMMONS. Thank you, Mr. Chairman and other members of the committee.

I am the chairman of the Securities Industry Association, on whose behalf I am testifying this morning. I am also a vice chairman of Shearson Lehman Hutton.

On behalf of SIA, I would first like to commend both your committee and the other congressional committees for the thorough and balanced manner in which you have conducted your hearings regarding leveraged buyouts. We appreciate the opportunity to participate in them.

The evidence already heard by your committee and by other congressional committees, suggest that LBO's are not a threat, either to the economy or to the Treasury. In fact, there has been considerable evidence that LBO's have a powerful economic rationale and help to advance corporate productivity.

The fears voiced by some that LBO's have resulted in too much corporate debt or debt exposure, or that LBO's have, in some way, hurt target industries or their employees have turned out to be unfounded.

Secretary Brady and others testified that the corporate sector is not overleveraged by LBO's or otherwise. Both Fed Chairman Alan Greenspan and FDIC Chairman William Seidman have stated specifically that banking institutions are not overexposed by LBO loans.

And Kathleen Utgoff, Executive Director of the Pension Benefit Guaranty Corporation, has testified that pension funds are not overexposed to LBO loans, and that, in fact, pension plans benefit from LBO investments.

Numerous respected economists have testified based on detailed empirical analyses that LBO's neither cause a loss of jobs nor have an adverse impact on R&D expenditures. And Secretary Brady and others have testified that the positive revenue effects of LBO's probably outweigh any negative revenue effects.

Other witnesses have testified as to the positive benefits of LBO's. In effect, LBO's are only one method among many developed by free capital markets to improve the allocation of resources in our economy. As such, one would intuitively conclude that LBO's should generally improve economic efficiency and its attendant benefits.

In January, SIA formed a committee to examine the affects of LBO's on the U.S. economy. Our committee, after examining numerous empirical studies, has completed a white paper on the subject which we have made available to everybody here.

That white paper concludes that LBO's have, in fact, played a positive role in efficiency allocating capital in the economy and in furthering improvements in corporate performance, productivity, and employment.

In light of our findings, we at SIA strongly believe that no tax changes should be made which are intended to curb them. The list of proposals which are before you today for consideration proceed essentially on the assumption that anti-LBO steps are warranted. Such proposals should be rejected.

We now live in a world of international capital markets and of multinational finance. Each of our major trading competitors already enjoy lower capital costs than do American corporations. None of our major trading partners currently faces the types of interest restrictions and tax penalties listed as options in your hearing notice.

We believe that it would be folly to restrict U.S. capital markets just as international competitive pressures are stiffening. This is particularly true as American companies face the spector of a single European market in 1992. American companies need help from their Government in competing with foreign enterprise. They should not be saddled with new competitive disadvantages.

The first group of options listed in the hearing notice would restrict corporate interest deductions in one way or another. Any such restriction would directly raise capital costs to American industry relative to our foreign competitors, each of which, it should be remembered, permits interest deductions in determining taxable income in their home countries.

Some of these proposals would limit interest deductions by fixing debt to equity ratios, or by restricting deductions on debt above a certain rate of interest. No other country imposes such restrictions. Such governmentally imposed restrictions would, by definition, be arbitrary and would skew U.S. capital markets relative to the rest of the world.

They would be particulary damaging to new and risky ventures, many of which are developing new industries and new products. Some options seek to penalize foreign investors because their home tax regimes permit interest deductibility. Such provisions would violate our most important tax treaties and would cause serious turmoil in international capital markets.

And as our experience with the 30-percent withholding tax on portfolio debt has shown, increasing taxes on foreign investors results either in capital costs to U.S. companies or a flight of foreign capital. Given today's global economies, such proposals simply won't work.

One of the reasons foreign countries have enjoyed lower costs of capital is that most do not subject dividends to double taxation. SIA supports the elimination of double taxation and the institution of a fully integrated tax system. However, the problem with the two-tiered tax in the United States is not that interest is deductible, but the distributed corporate earnings are taxed both to the corporation and to shareholders.

While we agree completely that the tax treatment of equity is a matter which should be addressed, SIA strongly opposes any plan to eliminate double taxation of dividends by instituting double taxation of interest.

I would point out as well that the effects of double taxation in the United States is exaggerated by the fact that our taxation of capital gains is the most harsh in the industrialized world.

Other options on your list involving excise taxes on LBO's or on fees generated by them are designed to inhibit the exercise of the free market in allocating capital and setting fees. SIA believes that tax policies should not be a hindrance to capital formation.

Past experiences with proposals seeking to restrict corporate interest deductibility have shown how fragile U.S. capital markets are in the global economy. Given our international competitive situation and our trade deficit, this is not the time to experiment with restrictions on U.S. capital formation and U.S. investment.

The available empirical evidence and the testimony before you show that LBO's are a marketplace phenomenon which generally have been of benefit to the efficiency of the corporate sector. The law should not be changed in reaction to LBO's.

[The statement of Mr. Simmons follows:]

STATEMENT OF THE
SECURITIES INDUSTRY ASSOCIATION
TO THE COMMITTEE
ON WAYS & MEANS
U.S. HOUSE OF REPRESENTATIVES
MAY 17, 1989

Mr. Chairman and members of the Committee, I am Hardwick Simmons, Vice Chairman of the Board of Shearson Lehman Hutton, Inc. and Chairman of its private client group. I also serve as Chairman of the Securities Industry Association [SIA]. I thank you for the opportunity to appear before you today as a representative of the Securities Industry Association.

SIA represents about 585 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types -- investment banks, brokers, dealers and mutual fund companies as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America. Because of their role in the capital markets, SIA members are in a unique position to recognize the effects of tax policy on leveraged transactions.

A. INTRODUCTION

On behalf of SIA, I would first like to commend the Chairman and this Committee for the fair and balanced manner in which you have conducted its deliberations on the sometimes controversial subject of leveraged transactions. As a result of evidence produced in your exhaustive hearings, Congress can now draw some conclusions regarding the tax policy aspects of LBOs. The inevitable conclusion, we believe, is that no changes in our tax law are either warranted or justifiable in response to the phenomenon of leveraged corporate restructurings.

LBOs have played a positive role in efficiently allocating capital in the nation's economy, with resulting improvements in corporate performance, productivity, and employment. The "leveraged buy-out" is one method among many developed by free capital markets to improve the allocation of resources in the economy. Conclusions regarding these positive effects have been summarized in an extensive White Paper regarding LBOs which SIA recently completed and is now making available to the public.

As noted in the White Paper, empirical studies have shown that most companies which have undergone an LBO have improved their profitability and productivity. These efficiency gains are often dramatic, with increases in operating income of 20-30% over pre-buyout figures. These gains result in part from the discipline imposed by debt service obligations, which require managers to make their operations more efficient. Moreover, because managers and employees often purchase an equity stake in the company, they have a strong personal incentive to seek new ways to improve profitability.

Over the past few months, the testimony presented to this and other Congressional Committees by representatives of the executive branch, numerous academics, and other private sector witnesses strongly suggests both that LBOs have a legitimate economic rationale and that they have no adverse effects on federal tax revenues.

The issues Congress has examined and the responses it has gathered in hearings to date are briefly summarized as follows:

1. Banking Institutions Are Not Unduly Exposed By LBO Loans.

Federal regulators uniformly agree that the nation's financial institutions are safely managing their participation in LBOs and that such financings pose no serious threat to the soundness of these institutions. Moreover, banking regulators recently have taken a number of actions designed to scrutinize more closely the banking community's involvement in LBOs.

Federal Reserve Board Chairman Alan Greenspan, in a letter to Senate Banking Chairman Riegle, stated:

> To date, evidence has not emerged to suggest that banking organizations are unable to manage the risks associated with LBO-related loans. Lending institutions appear to be giving special attention to the credit analysis of LBO transactions.
>
> Given these [supervisory] policies regarding LBO loans and holdings of high-yield securities, risks to the deposit insurance fund seem to be reasonably well contained.

FDIC Chairman William Seidman, in testimony on January 31st, advised the Committee that banks are prudently managing their loan exposures and that the FDIC does not perceive any serious threats posed by such financing to the U.S. banking industry. On the same day, Comptroller of the Currency Robert Clarke told the Committee that banks have imposed limits on their LBO loan exposures and that risks associated with LBOs do not differ substantially from other lending risks.

Federal banking regulators have recently taken a number of additional steps both to insure the security of those lending institutions involved in LBOs and to protect federal guarantors. This February, both the Federal Reserve and the Office of the Comptroller issued additional instructions to their examiners regarding bank loans used to finance LBOs. Similarly, in January, the Federal Savings and Loan Insurance Corporation issued new guidelines regarding investments in so-called high risk securities.

2. The Corporate Sector Is Not Overleveraged Due to LBOs or Otherwise.

The contention that LBOs have led to a rapid increase in corporate debt is simply not true. The recent trend in LBO activity has had no discernible effect on overall corporate debt to equity ratios. LBO debt constitutes only a small portion of overall corporate debt. Corporate debt, in turn, has not been the driving force behind the overall rise in U.S. debt; that distinction belongs to the accumulated federal deficit and to household debt.

Corporate debt as a percentage of the GNP is only slightly higher now than it was in 1970. Secretary Brady told both this Committee and the Senate Finance Committee that, "if debt and equity are taken at market rather than book value, current leveraged ratios, although rising, remain well below the peak levels of mid-1970s, and are in line with the average over the last fifteen years."

Professor Alan Auerbach of the University of Pennsylvania testified that current debt to equity ratios are not unprecedented for the United States and as yet do not compare to those observed in several other industrial countries, such as Japan. Professor Lawrence Summers of Harvard told the Committee that notions of overleverage and fears that LBOs pose dangers to the economy are "probably exaggerated." He said that increases in corporate leverage reflect financial innovations which have reduced the costs of capital and improved business efficiency.

3. LBOs Do Not Cause the Loss of Jobs.

Professors Jensen of Harvard University, Kaplan of the University of Chicago, Michel and Shaked both of Boston University and Ribstein of George Mason University have all offered testimony to the same general effect that LBOs have not caused a loss of jobs. Based on recent studies, a number of witnesses have indicated that LBOs have been responsible for a reversal of the decline in target enterprise employment and an increase in jobs. This accords with the conclusion reached in our White Paper.

Professor Ribstein went so far as to state that: "If anything, restricting LBOs may actually cost jobs."

4. LBOs Do Not Have An Adverse Impact on R&D Expenditures.

In his testimony Professor Jensen concluded that "buyouts have little effect on R&D spending because the acquired entities seldom engage in extensive R&D." Indeed, companies most appropriate for LBOs are not in high technology businesses and do not require large-scale research and development to remain competitive. Erich Block, Director of the National Science Foundation, noted that an NSF study had found that firms which underwent LBOs were not among the major R&D performers. Most studies on the impact of LBOs on R&D and capital spending clearly do not support the proposition that these activities are adversely affected.

5. Pension Funds Are Not Overly Invested in LBO Debt.

According to testimony presented to the Committee in January, only a small number of pension funds invest in LBOs, and that total pension fund investment represents only approximately two tenths of one percent of total pension assets. Moreover, although pension funds account for approximately 15% of all high-yield purchases, this amount represents less than 1% of total pension assets.

As stated by Dr. Kathleen Utgoff, Executive Director of the Pension Benefit Guaranty Corporation before the Committee in January:

> There is little evidence to date that pension fund assets are either the culprit or the victim of LBO activity ...
>
> [Moreover,] there is evidence to support the belief that LBOs increase efficiency and the value of a company and that pension plans can benefit from that increase in value.

6. LBOs Do Not Decrease Federal Tax Collections.

In his testimony last January to the Committee, Secretary Brady acknowledged that leveraged acquisitions increase tax revenues in three ways, and that these increases may more than offset revenue losses from any increase in corporate interest deductions. These three increases come from additional stock gains realized by shareholders, from sales of assets by the acquired company in order to pay off debt, and, to the extent that LBOs enhance productivity, from an increase in the overall level of national income.

In February, Professor Jensen testified that, based upon analyses he has performed, "the U.S. Treasury gains significantly from buyouts." Mr. Jensen estimated that increases in revenues due to buyouts exceeded any decreases by half, and that firms' post-buyout annual tax liabilities have exceeded pre-buyout liabilities by over 60%. Mr. Jensen calculated that the RJR Nabisco transaction alone will generate net Treasury gains of $3.8 billion, and that $3.3 billion of this will occur in the year after the buyout. Both Professors Levin and Kaplan have also testified that, in general, the Treasury gains, not loses, from buyout transactions.

* * * * * * * * * * *

The testimony you have heard to date constitutes a rather resounding rejection of the various criticisms leveled at LBOs immediately prior to your hearings. Indeed, many witnesses have informed the Committee that LBOs have made corporate operations more efficient and competitive. Proposals that would penalize these transactions without regard to their effect on what is essentially a market driven phenomenon can only increase the cost of capital for U.S. corporations and undermine their international competitiveness. Certainly, U.S. business cannot afford to embark on such a course while responding to the competitive challenge of a global economy.

B. LEGISLATIVE OPTIONS

The Committee's hearing notice contains twenty-seven options relating to various tax policy aspects of corporate restructurings. The sheer volume of the entries on the hearing notice evidences wide-ranging views on the subject, and their diversity argues powerfully that the subject area is extremely complex. It illustrates that there is no consensus that a tax policy problem exists, and that if there is a problem, neither its exact nature nor any appropriate legislative response has been identified.

In considering these proposals, the Committee is also proceeding against the backdrop of the antitakover tax provisions it considered in the context of the Revenue Act of 1987. Those provisions would have limited the interest deductions associated with debt used to finance corporate takeovers, going-private transactions and recapitalizations. A recent study released by Securities and Exchange Commission staff economists concludes that the consideration of these provisions significantly contributed to the October 19 market crash. This carefully compiled analysis should certainly cause the Committee to pause before going down the same road again.

The twenty-seven options can be divided into five general areas: 1) limiting deductions for interest; 2) increasing taxes on foreign investors to compensate for foreign interest deductibility; 3) placing an excise tax on corporate recapitalizations and reorganizations; 4) imposing an excise tax on the income of investment bankers; and 5) restricting the use of ESOPs. The proposals, except for restricting ESOPs, are discussed under these groupings below. SIA will not address ESOPs because they have been carefully scrutinized in earlier hearings in the Oversight Subcommittee.

The hearing notice also raises for discussion the question of two-tier taxation and possible mitigation or elimination of the second level of tax on corporate dividends. This matter is examined under a separate heading.

1. Restricting Interest Deductions

One option before you would simply reduce the aggregate amount of interest costs which a corporate borrower could deduct. Such a limitation would affect all borrowings by any type of business enterprise, and would unavoidably raise the cost of capital to those businesses. By definition, this would be harmful to American industry, restricting its ability to invest, expand, and compete with foreign firms. It would be particularly disadvantageous for financial institutions, utilities and other businesses which must finance inventory with debt. Furthermore, such businesses are not conducted solely by specific and easily identified industries or corporations. For example, some corporations borrow money and lend it to customers to finance the purchase of their products, some borrow money and use it to lease equipment to other corporations, and others have large divisions actively engaged in selling financial products. There is no simple way to isolate these businesses and treat differently the amounts borrowed. Money is fungible and an amount borrowed to support one operation can support other operations within commonly controlled corporations. Likewise, a corporation can choose which operations to borrow against for working capital, and which to "support with equity", which loans to leave outstanding, and which to pay back. It is difficult, if not impossible to sort out the "purposes" for which the debt of related corporations is carried or paid off.

A limitation on interest deductibility would also fundamentally undermine the entire theory of the corporate tax, a levy designed to be imposed on income net of expenses. This would be a dangerous precedent. Each of our major trading partners and competitors allows for deduction of interest in computing net corporate income subject to tax. Japanese, German and other major foreign corporations already enjoy significantly lower capital costs than do American corporations. It would be folly to raise costs of capital for American corporations by restricting interest deductibility just as international competitive pressures are stiffening. This is particularly true as American companies face the specter of an single European market in 1992. One can only wonder what could be viewed as so seriously amiss in current law as to prompt the Congress even to consider a general, across the board limitation on corporate interest deductions.

A second group of options would place interest restrictions on borrowings either to the extent to which such borrowings put a company in excess of governmentally dictated debt to equity benchmark ratios or on instruments to the extent the interest thereon was above governmentally dictated rates. In general, these types of provisions require the federal government to undertake qualitative and quantitative judgments about corporate indebtedness which have heretofore been the province of free capital markets. Moreover, the consideration of such proposals will eventually result in the complex vagaries associated with special carve-outs needed to address the problems of companies which must finance their inventory with debt, of small business, and of start-up ventures.

We now live in a world of international capital markets and multinational finance. Even if we wished to set capital standards by government decree for the United States, we are simply unable to set them for the rest of the world. The result would be a less efficient American business community competing against unburdened foreign enterprise. Therefore, proposals seeking to establish capital standards should be rejected.

Looking at this group of options more specifically, the first type would operate by deeming any debt in excess of a maximum debt to equity ratio to be equity, and by deeming any payments made thereunder to be non-deductible dividends. We believe that this approach would be highly arbitrary and fraught with danger. As the Committee knows, current law already provides a mechanism whereby purported debt can be reclassified as equity for tax purposes. Numerous court cases have been decided in this area over the past 50 years.1/ This substantial body of law takes into consideration numerous indicia of both debt and equity, including, among others,

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1/See discussion, In Re: Lane, 742 F.2d 1311, at 1314-15 (11 Cir. 1984).

the degree and nature of enterprise control exercised by debt holders, the convertability of debt to equity, the ability of expected cash flow to service debt, and the nature and extent of debt subordination. While these criteria are not arbitrary, reclassifying debt as equity based on fixed ratios would be arbitrary. There is no indication that existing case law is inadequate. There is, however, much reason to fear that enacting flat statutory standards will result in a burdening of the free flow of capital, and in adverse effects on the efficiency and competitiveness of American business.

The second type of option in this group would disallow deductions for interest in excess of a fixed rate. In effect, this would deem an indebtedness to be partially debt and partially equity. Setting a single allowable rate would have many of the same negative effects as would dictating allowable debt to equity ratios. Different firms have different credit ratings, and must pay different interest rates. Small firms, start-up firms, and high technology firms, which frequently tend to pay higher interest rates, would suffer disproportionately from such a restriction.

Another group of options would link restrictions on deductibility to the intended use of the borrowing, that is, for the purpose of making an acquisition. One option would restrict the deduction only on indebtedness used in a "hostile" purchase of a publicly traded company, while another would go so far as to cover all public and private stock as well as all asset acquisitions. Such options might even reach to borrowings the proceeds of which are used directly or indirectly in stock buybacks and extraordinary dividends or redemptions. The Committee would confront many difficult choices and decisions in composing the scope and workings of a tax penalty along the lines of the above. Tax experts have testified before this Committee that a provision designed to single out certain types of transactions would be virtually unworkable.

The unavoidable questions raised by such "targeted" or "focused" tax penalty proposals in the hearing notice are: what exactly is Congress attempting to accomplish by enacting such a provision? Does Congress wish to foreclose certain types of transactions? If so, which ones, and why? Is the Committee trying to make certain forms of capital investment less attractive? Is the objective simply to raise revenue?

It is possible to engineer the tax laws in an effort either to promote or deter market investment choices. The long and sometimes heated debate over appropriate depreciation allowances for capital assets is one example of a tax based effort at guiding the pattern of business capital investments. If Congress is inclined to manipulate the tax deductibility of interest in order to achieve specific goals, it should be clear as to what those goals are. For its part, SIA believes strongly that Congress should not attempt to direct the use of borrowed capital by fine tuning the corporate interest expense deduction in any manner or form. The allocation of capital is best left to the marketplace.

The Committee's hearings began with a focus specifically on LBOs, a concept which in itself is difficult to define and describe. The hearing record simply has not established any reason to attack LBOs through some form of targeted interest restriction provisions. If anything, LBOs, which in essence are a form of corporate asset redeployment, have been shown over the course of the hearings to have an important economic rationale.

Finally, we note that one set of options restricting the deductibility of interest would change the economic accrual rules for recognizing interest expense on original issue discount obligations. One notion would be to disallow interest deductions until actual cash payments are made. However, Congress adopted the economic accrual rules because it believed that cash accounting concepts were inappropriate for discount obligations. Congress concluded that the most appropriate way to measure both income and expense from these obligations over their duration was to employ accrual methods of accounting. Congress focused specifically on these rules originally in 1969, again in 1982 and yet again in 1984. Changes in the calculations of the interest deductions on discounted debt were made expressly for the purpose of placing such deductions on a footing parallel with interest paid or payable on non-discounted debt obligations. The fact that a tax-exempt investor might be the holder of the debt was wisely not considered to be relevant to the central question of accurately measuring and allowing the amount of interest deduction to the borrower.

To readjust the original issue discount rules to provide for different treatment specifically for an obligation issued in conjunction with a leveraged transaction (or alternatively, for such obligations but only when held by non-taxable investors) would insert a new layer of administrative and interpretative complexity to those already complicated provisions. Moreover, it would not be an action based on a flaw in the accepted economic accrual accounting concept so carefully crafted over a period of twenty years. It would instead be a tax penalty designed only to restrict LBOs. As already noted, the SIA believes that LBOs have provided an innovative mechanism for U.S. corporations to improve economic performance, enhance efficiency, and become more competitive in the face of a changing world business environment. The Committee's own hearing record has established no basis for any kind of anti-LBO tax legislation, including changes in the deferred interest accrual rules.

2. Increasing Taxes on Foreign Persons to Compensate for Foreign Interest Deductibility

This second group of options seeks to balance a U.S. restriction on corporate interest deductibility with a special tax on foreign investors who are, of course, permitted to deduct interest expense when computing their taxable income under their home tax regimes. Penalizing foreign investors with a new tax would have only one effect: it would raise the cost of foreign capital to U.S. corporations. The continuing U.S. budget and trade deficits make it imperative for U.S. corporations to seek both equity and debt financing from abroad. Capital costs to U.S. corporations are already higher than for our principal foreign business competitors. Attempting to increase U.S. taxation of foreign persons, besides violating some important existing U.S. tax treaties, could cause a flight of foreign capital from the United States, with attendant effects on the value of the dollar, the U.S. economy, and federal tax revenues. At one time, U.S. tax laws contained a 30% withholding tax on interest payments made on portfolio debt to foreign investors. The repeal of the withholding tax on portfolio interest in 1984 was made after Congress considered the practical and policy issues at length. At that time, Congress concluded that it was important for U.S. businesses to have access to foreign capital markets, particularly the Eurobond market, and that the imposition of a withholding tax on portfolio interest impaired the ability of U.S. corporations to raise capital. Capital markets are now worldwide and respect no national boundaries. Any new tax on foreign investors will be borne, one way or other, by U.S. firms.

3. Placing an Excise Tax on Corporate Recapitalizations and Reorganizations

The third group of options involves either taxing corporate reorganizations via an excise tax or taxing unrealized appreciation of assets. Our tax system is based on the premise that no income is subject to taxation absent a "realization event." Our tax code also recognizes that reorganizations and recapitalizations are frequently necessary to ensure the most efficient allocation of capital. In instances not resulting in realization events, the act of reallocating assets in corporate solution should not be taxed. To do so would prevent the most efficient allocation of those assets. Elements of the tax code which previously were viewed as favoring or encouraging corporate acquisitions, i.e., the General Utilities doctrine and the possible carryover of net operating losses, were removed or effectively restricted in the Tax Reform Act. It would be particularly unwise to add new artificial burdens to market generated efforts to organize or adjust U.S. capital allocations by adopting new taxes designed to discourage acquisitions or asset dispositions. By placing a tax on restructurings, Congress would in effect freeze existing corporate capital structures and insulate them from future market determinations regarding the most productive use of that capital.

4. Introducing an Excise Tax on Banking Fees

The fourth group of options would put some kind of excise tax on fees generated in corporate restructurings. Such options involve little more than increasing the tax burden of an individual or firm but essentially on the type of work which produced the income. LBO associated fees, like all fees for services, are dictated by market forces and are subject to competitive pressures. As stated by Treasury Secretary Brady before the Committee in January, "if fees are too large, it doesn't take very long before competition comes in and drives them down." Taxes are paid on income earned through those fees by banks and bankers, lawyers, accountants, and others at rates applicable to all who earn similar amounts, regardless of the business activity which generated that income. There is no reason why income from such activities should be singled out for special tax levies or higher tax rates. Moreover, governmental determinations regarding the type of income appropriately subjected to a special punitive tax would be a startling and unfortunate precedent in our income tax system.

DIVIDEND RELIEF - TWO TIER TAX

The hearing notice also identifies dividend relief as an area of the Committee's inquiry. The two-tier tax has periodically been noted as a problem, philosophical and practical, since the inception of the corporate income tax over seventy years ago. SIA strongly believes that dividend relief would be a positive change and supports the idea whole heartedly.

However, SIA strongly opposes the notion that the revenue cost associated with any version of equity relief should be defrayed by off-setting revenue raising restrictions on corporate interest deductions. Debt and equity are both legitimate methods of raising capital. The problem with the two-tier tax is not that interest is deductible, but that distributed corporate earnings are currently taxed both to the corporation and to shareholders.

The options which provide needed relief to one form of business capital, i.e., equity, but which also impose restrictions on interest deductions ironically will wind up damaging the other form of business capital, i.e. debt. Dividend relief tied to interest restrictions would produce a wide and unpredictable pattern of benefits and detriments among American companies based upon their ability to pay dividends. In particular, many small and medium sized firms, as well as firms under strong competitive pressures, are frequently unable to declare dividends.

In addition, the dividend integration schemes in place among our major foreign competitors are in no way constructed on a linkage between dividend relief and interest deductibility restrictions. If the two are tied together, American corporate enterprise could only suffer a disadvantage relative to foreign enterprise. The net after tax cost of corporate capital, whatever its form, is a vital element of global business competition; one reason American companies have turned increasingly toward debt financing is to bring capital costs more in line with foreign competition. There is nothing in the hearing record that could possibly warrant Congress taking steps to mitigate the two-tier tax at one level tax while simultaneously worsening it at another. To do so would produce unpredictable, scattershot benefits and detriments among firms based not on market-determined efficiency or profitability, but on arbitrary government policy. This could only damage the competitive standing of American firms in the world market place.

C. CONCLUSION

No convincing evidence exists to suggest that LBOs are a source of either economic or tax revenue problems. On the contrary, the extensive Congressional hearings conducted to date have produced considerable evidence that LBOs are primarily mechanisms, created and shaped by the market, which help allocate capital more efficiently in the U.S. economy. Therefore, we believe that tax changes directed at LBOs are neither necessary nor justified.

As regards the various options on the Committee's hearing notice, each carries with it serious risks. Each seeks to use the tax code to influence investment behavior and capital allocation, a task which nearly all economists today agree should be left to the marketplace. In addition, any change in the tax treatment of financial transactions must be approached with utmost caution. As evidenced in October of 1987, even ostensibly small changes can contribute to great and unpredictable upsets in capital markets, both foreign and domestic. It should also be remembered that Congress, in enacting the Tax Reform Act of 1986 and subsequent legislation, has made major changes in the taxation of business and financial transactions. Taxpayers are now only beginning to understand and incorporate these changes into their business dealings. A fresh set of yet more changes in law could be seriously counterproductive.

Other LBO issues, such as those involving insider trading or the protection of creditor or stockholder rights, may require additional scrutiny from regulatory agencies or additional protective legislation. We note but do not address these issues, as they are not of a tax policy or revenue nature and legislative action, if appropriate, would lie with other committees of the Congress.

Chairman ROSTENKOWSKI. Thank you, Mr. Simmons.

Mr. Flippo will inquire.

Mr. FLIPPO. Thank you, Mr. Chairman.

I appreciated the testimony of our witnesses today. You mentioned a new study, Mr. Simmons, that your organization is making available today, a new white paper, I believe.

Could you tell me if that study demonstrates that we have an increased return on total funds invested in LBO's? I mean, we're borrowing huge sums of money, we're certainly increasing the corporate debt in these buy-outs. I understand that certain efficiencies are accomplished.

But what I'm trying to understand is, is there documented evidence that shows an increased return on invested capital in your studies?

Mr. SIMMONS. Well, if you're talking about increased returns on shareholder equity in those corporations that have been subject to LBO's, my guess would be that there are enhanced shareholder returns there.

Mr. FLIPPO. But let's say I'm talking about—I'm interested in the total dollars that are invested there. I mean, capital is obviously a great problem for us in this country since we borrow so much from abroad. I'm trying to understand whether or not LBO's create increased return on total assets managed, total return on assets invested, and are there any studies that demonstrate that, or perhaps, Mr. Pickens or Ms. Sullivan would like to respond.

Mr. SIMMONS. I find your question somewhat confusing, Congressman, because on those moneys that are invested in the LBO itself, there are enhanced returns on the debt section, much of it being higher priced debt than perhaps debt was there before to the individuals that own that debt.

But in terms of the corporation itself, when it looks at its overall return, it would look at its overall return on equity and its overall return on equity would probably be higher, assuming that it met its targets.

Mr. FLIPPO. Well, I certainly didn't mean for my question to be confusing. Let me try it again.

Corporations, prior to takeovers, have certain assets that they're managing. I'm trying to see if LBO's result in increased asset management, and I'm trying to see, are there any studies that show the total investment in this new corporation, debt, and equity—I'm trying to find out if there are any studies that show that LBO's result in total, greater asset management. Mr. Pickens.

Mr. PICKENS. I can't cite a study to direct you to. My personal feelings about it are that—if I might just go back to the start and the way I see these things—there's no LBO that's ever going to be made unless the management has done a poor job of managing assets. That's the only reason that it's there. It's the same way with a takeover.

If management has done a good job, then there's never any inducement for anybody to do it. So, I'd have to believe, with that thinking, that when you take the stockholders, the common stockholders, out—let's go to RJR-Nabisco for instance.

The management there offered $17 billion for the assets of the company, and it was thrown open to an auction, and it was sold for

$25 billion. Well, that makes me very nervous that management would want to buy those assets at $17 billion when they sold to another bidder for $25 billion.

Now, the common shareholders are out at that point. So, the people that acquired that, KKR, certainly believes, or they would have never done it, they would never have made the purchase, if they didn't believe they could manage the assets than the prior management. I have to believe that, too.

Mr. **Flippo**. Well, I understand that we believe that and that that's what we hope, is that we have more efficient management after the LBO than before the LBO, but I'm looking for some evidence that shows a greater management of assets after the buyout than before the buyout, and I understand what you're telling me in terms of return on equity capital.

They have a certain pot of assets that they're managing prior to a buyout and, obviously, according to the theory, those are being managed rather poorly. After the buyout, you have an even larger pool of assets to deal with.

I'm asking, is there any evidence that management has done a better job on return on total investments?

Mr. **Pickens**. I think the evidence that you have is that the managements that made the purchase are operating those assets. If they weren't, we would have had a disaster, and I'm not going to tell you there won't be some disasters, too. But I think you find that the management is still around, they're managing the assets, and also managing their debt, which indicates to me they're doing a better job.

Mr. **Simmons**. Let me just come back to that just for a moment. Maybe I can understand that question a little bit better.

Actually, if you go through a leveraged buyout, the assets in the corporation don't necessarily increase. The capital underneath them may convert from equity to debt to a greater extent, but the assets being managed by the corporation wouldn't necessarily increase.

I think that studies—and there have been studies on both sides of this question—to date, have shown that those assets tend to be more efficiently managed in the LBO forum. Thus, the after-tax return divided by the overall assets that went into the transaction, would be more efficiently run and the returns would be higher. That's the general finding that we've found so far.

Ms. **Sullivan**. Of course, I don't agree. I don't agree with that at all. I mean, what do they do? They take up a good company, a working company, a successful company, break it up into pieces, then they get all of these junk bonds, and the real permanent bondholders suffer right then. That's absolutely true, because the price goes down, their position is not as good a position, and they have lost.

Now, what happens with all these little bits and pieces? Anybody can tear up something. I mean, that's easy. But we have to be builders. So you can see, I can't agree with you. I really can't. I know I'm against two distinguished gentlemen and I'm here alone, but I don't agree with them.

Mr. **Pickens**. Could I just take 1 second? If you would refer to the study of the University of Chicago by Kaplan, which is a recent study, it is one that addresses more efficiency and productivity from LBO firms. And it's cited in our bibliography that we turned in today and made it a part of the record of this meeting.

Mr. FLIPPO. Well, I will conclude, Mr. Chairman, and thank you for your patience, and I appreciate the response. But I would like to request that if you have any evidence that corporations better manage total assets and increase ROI, I'd be grateful for it.

Thank you very much for your comments.

Chairman ROSTENKOWSKI. Mr. Pickens, you state in your testimony that if the stock price of a corporation fully reflects the value of its assets, it won't be vulnerable to a buyout because nobody would be capable of making a profit from it. But we have heard during the previous testimony, the debt, since it is deductible, has the effect of increasing the potential value of a corporation by the amount of tax subsidy.

How do you respond to that analysis?

Mr. PICKENS. Well, we—and I'm out of the business and I announced that over a year ago.

Chairman ROSTENKOWSKI. Yes, but you're an expert, Mr. Pickens. I think you can share with us.

Mr. PICKENS. I agree. If I'm not an expert, I should be with all the experience I've had.

But we have, in looking at these situations, we have really never considered the tax advantages to an acquisition. The assets are going to have to sit on their bottom and the value has to be there or the offer is not made.

That's it. I just don't believe anybody is going to pay more than the asset value because of some tax advantage.

Chairman ROSTENKOWSKI. You don't think that debt has any relationship——

Mr. PICKENS. The debt has to because our tax laws are biased to the point where debt is preferred over equity. But I don't think that—let's go back to RJR-Nabisco. I love that deal. It has all the——

Chairman ROSTENKOWSKI. How much did Johnson get in this from a balloon, parachute, or whatever you call those things?

Mr. PICKENS. I don't know. A lot more than he deserved.

Chairman ROSTENKOWSKI. Yes. [Laughter.]

I think I do know. Not a bad deal.

Mr. PICKENS. But look what happened to Johnson in the deal, too. He gets smeared on the front of Time magazine as epitomizing greed and everything else, and I'm sure he wishes he had never made that $75 offer for RJR because he was a dreamer to think that was ever going to happen.

But if you look at that situation—I'm supposing, and I would imagine that Mr. Simmons knows better than I do about what equity went into the RJR deal—but I'm guessing not over 20 percent equity in it, is it?

Chairman ROSTENKOWSKI. Mr. Simmons is going to avoid RJR-Nabisco this morning.

Mr. PICKENS. He's an expert on that. But you have 20 percent equity in it and so you're talking about $20 billion worth of debt someplace in there, which is a huge amount of debt to make an acquisition that size, but I can assure you, the people that made the deal, I have great confidence in. I have nothing in the deal.

I was an RJR-Nabisco stockholder and I sold out at $103 or $104, and tickled to death to get it. And so, when you look at it, you know what's going to happen to RJR-Nabisco. I think it's going to be managed more efficiently than it ever has before.

Those assets will, in some form or another, will be a better—and you're going to see a lot of spinoffs out of there, which I like that. I like spinoffs out of these giant companies. I think it's better to go ahead and break them up and let those particular entities start to develop into another giant company, so to speak.

Chairman ROSTENKOWSKI. Mr. Pickens, you mention in your written testimony that an LBO may leave some companies with very small margins for error, particularly in bad economic times.

Do you have concerns regarding the solvency of some LBO transactions if the country should experience a downturn or a recession?

Mr. PICKENS. I do, because our system is not one that is perfect where we can make every deal a good deal. There are going to be some bad deals. There are going to be some that have failed. But when you tell me that debt is bad and just generally, throwing everything into that particular category, I have to then assume two things.

One, the person that borrowed the money is not very smart and the person that loaned the money is not very smart, and I'm not willing to make those two assumptions. At the same time, I know that not every deal is going to be a good deal. I know that because I've been around too long.

Chairman ROSTENKOWSKI. Mr. Simmons, I note from your testimony that you advise a select group of clients.

What are you telling your clients, if you can share the information with us, about the potential dangers of an economic downturn on high leveraged transactions?

Mr. SIMMONS. Well, Mr. Chairman, what we do—and Mr. Pickens is very close to what we do—what we do is, there are so many tiers of lenders in most of these leveraged buyout transactions, that the credit analyses that are done are done on multiple levels.

What we do, for instance, is we take each of these companies, put it through a model which literally ratchets down through different economic scenarios, to what we think would be the worst of economic scenarios over the next 5 years or the point in which the company might be in most danger from a cash flow point of view, and then carefully price whatever offer there is on the basis of that model.

So, we do that, the senior lender or the bank does that, other mezzanine lenders do the same thing, and as a result, I think by the time that the price is agreed to for any sort of a bid in these cases, we're pretty satisfied that what we have is a model that will stand up or a company that will stand up to very poor times.

I might also say that the companies that are best done in leveraged buyout transactions are generally not durable goods or cyclical companies. They tend to be noncyclical, nondurable goods companies—a food company would be a good example of that—which are essentially defensive in nature and which provide a great deal of cash over a period of time on a highly visible basis. You can look forward 4 or 5 years and pretty much know people are going to eat Oreo cookies.

As a result, I think they tend to be the best and generally, our counsel is to stay with those industries in any sort of an LBO formation.

Chairman ROSTENKOWSKI. Thank you, Mr. Simmons.

Mr. Dorgan will inquire.

Mr. DORGAN. Thank you, Mr. Chairman.

The testimony of all of you is excellent, and we appreciate it.

Mr. Pickens especially, let me offer a proposition and ask you to comment on it. I think you start with the assumption that the market assessment of the value of assets is an exact mirror of the underlying realities. You start with that, and you reach the conclusion you reach.

Let me ask you to consider two companies, both publicly traded, one owned by me and one owned by Donald Trump; across the street from each other, the same asset base, same employees, same buildings, producing the same product. But we have different styles. His style is to take those assets and squeeze every last drop of profit out of those assets for the next quarter and trumpet those profits all over town. That is his style, and that is his goal.

Mine is to take those assets and build for the long term, to compete internationally, to do the best I can. I build the foundation, do the careful, considered things you should do, investing in R&D, and basically the best job I can for the long term, not necessarily so concerned about whether I get the last drop of profits out of the next quarter.

Question: Which company is likely to have the better evaluation by those who determine asset values in the market? And which company is to be the more likely target of a hostile takeover, in your judgment?

Mr. PICKENS. Well, I can give you an example of a company that does not make any profit at all and sells at an unusual price. It is the underlying value of the assets because they are talking about the long term, as far out as 5 or 10 years. So whether it is company A or company B, I think the market does a pretty good job of evaluating companies, and also management.

So, I mean, look at my case. I started a company with $2,500 in 1956, went public in 1964, and have been around for, what, 25 years as a public-owned company. Today, with that start of $2,500, we are now distributing $250 million a year to our stockholders in dividends. I am a great believer in——

Mr. DORGAN. I understand that. I mean, but——

Mr. PICKENS. But let me just say, I am going to give you an example here. You say the quarter by quarter. I am pouring out $250 million a year to 176,000 stockholders, and we are selling for $10.78, which is probably 20 percent discount to the underlying value of the assets. So I am the guy in the case that you are talking about, but I am also the guy in the other case, because we are pouring out a lot of money to our stockholders.

So I think that the market is quite capable over an extended period of time to evaluate company assets.

Mr. DORGAN. Do you agree that the market will always overvalue some and undervalue others?

Mr. **Pickens**. I think that when you see a company that is undervalued in the marketplace, what you are seeing is the market is telling you that if you are going to play this team, if this is going to be the management of these assets, it is not worth any more than this. And I can give you an example for that.

In 1983, when Gulf Oil was selling for $37 a share and had not gone up over 10 percent in 15 years, and the value of the assets were $109, I think the market at that time was telling the Gulf management and stockholders: If you are going to play this quarterback, this is all your worth, $37. I really believe that. I think the market can evaluate management.

Mr. **Dorgan**. The difference in our perspective, I think—and I respect your observation. The difference is that I think we are in a period in this country where if you take some assets and do what you think you need to do to strengthen them for the long-term pull, the long-term competition, to build the basis, the foundation of the company, I think you risk having somebody out there scavenging for undervalued assets. You risk that the market will not understand what you are doing in the long term, patient way of building your business. You risk it because you have got other folks out there who are squeezing the last drop out of the next quarter and holding a press conference every Friday, and the market says, God, these are real jazzy stocks.

Mr. **Pickens**. I do not think stockholders are that stupid, Mr. Dorgan.

Mr. **Dorgan**. Nobody is talking about stupidity. We are talking about market evaluation. I think the evidence supports——

Mr. **Pickens**. The stockholders buy the stocks, and I do not think they buy the hype, is my point. And I think that you would be surprised how sophisticated a lot of stockholders are about short-term motives and management.

But if you are a good manager, you manage for the short term, you bet. You manage for the intermediate and you manage for the long term, but you do not just keep making speeches about "I am a long-term builder of assets." Somebody finally says, well, when are we ever going to get the payoff.

Mr. **Dorgan**. The people who have engaged particularly in the LBO activity, almost all of them tell me the financial technique is to manage the cash-flow, because cash-flow is the name of the game when you have to pay the kind of interest payments you have to pay on junk bonds and high-yield debt.

The management to cash-flow suggests that somehow the depreciation account is irrelevant. Is that dangerous in the long term because depreciation reflects the charge for using up your capital stock? Is that a dangerous game?

Mr. **Pickens**. Well, see, again, you throw in long term, for the long term. To me, I am a manager for every term. And so, you know, I am going to take in all factors. Cash-flow is a key to it, but my job as a CEO of a large independent oil and gas company in the United States is to do the best I can with the capital I have available to me. That is my responsibility. That is my fiduciary responsibility to 176,000 people. And I am going to do the best I can with the capital I have available to me, because that is what I am paid to do.

Mr. DORGAN. But be careful if somebody out there does not think that you are not getting every last dime of profit out of the next quarters, because they might undervalue you. And if they undervalue you, you are the target.

Mr. PICKENS. Listen, if they can do a better job with the assets, they ought to be able to run them. And I have said many, many times, if anybody wants to make an offer for Mesa, that I will take the offer directly to the stockholders. I will try to get a better offer. But I will not spend one dime to keep that offer from going to the stockholders with any kind of legal maneuvering.

Mr. DORGAN. And that is where I think the debate is here. The question is: What is the assessment of the better job? Is it the assessment of those who want to take companies apart? Is the better job defined as the person who plans for next week and next month and wrings the dollar profit out of the next quarter? Or is the better job defined as somebody who patiently builds to strengthen for the long term?

You have just had some experiences, I have read, in Japan with respect to I guess takeover attempts.

Mr. PICKENS. No, wait a minute.

Mr. DORGAN. All right.

Mr. PICKENS. What I said there, we became the largest stockholder and the first stockholder in a major Japanese corporation, which is Koweto Manufacturing. I said there we are not trying to take you over. There is nothing hostile about this. We want to be a long-term stockholder. We want to be constructive. We want to help you expand your market. And I want to have three people on your board of directors.

Now, that is what I said.

Mr. DORGAN. Yes. It is a definitional problem, I guess.

Mr. PICKENS. I guess so.

Mr. DORGAN. The point I was trying to make with Japan is—in fact, that we compete with some smart, shrewd, tough competitors worldwide. My point is that in at least some other areas, there are some things we do not want to emulate; but some of the things we might want to emulate with respect to the Japanese is the understanding of the long term; that patience is a virtue, and that you are not competing just for next July. You are competing for the next 2 years, 5 years or 10 years. That is something, I think, that we need to pay a little more attention to in this country, and I worry that the LBO activity has persuaded most in this country, load yourself up with debt to be defense or plan for the long term at your own risk.

I worry about that. Maybe my worries are unfounded, but if not, then this country is in for a tough long haul unless we make some changes.

Mr. PICKENS. Well, let me tell you, I am a 4-day wonder on Japan. I went there for 4 days and got a real good lesson. But I can tell you, I mean, the long term for Japan may be long term in some ways, but their Nikei Dow, I can tell you, is a sham. I mean, the Nikei Dow at 34,000. If you have not examined that, you ought to take a look at it. You have got companies there that are selling for 100 times earnings. If you had 100 times earnings in America, you would have instead of the Dow average today at what 3,400 or whatever—is that about it?—2,400, yes. You would be looking at something like 24,000.

Mr. **Dorgan**. You are an optimist.

Mr. **Pickens**. So you are looking at something that is entirely different when you start to compare the Japanese financial markets to the U.S. financial markets.

Mr. **Dorgan**. But I was not comparing the financial markets at all. What I was comparing is the notion that what we are doing here is more than just tomorrow. It is the long term. And I worry that in this country you cannot do that very well as a CEO.

I might tell you that your attack over the years has been a kind of a populist attack, and none of us here want to be in the position of supporting slothful, indolent CEO's to the extent they exist. On the other hand, I am not interested in somebody that wants to make a lot of money taking things apart and selling and buying them in the short term. I am interested in something in between in which we persuade our companies to use the assets they have in the most productive way possible for the long term for this country in international competition.

I have used my time.

Ms. **Sullivan**. Can I talk to you?

Mr. **Dorgan**. Yes.

Ms. **Sullivan**. You know, I am with you. I agree with you.

Mr. **Dorgan**. Thank you.

Ms. **Sullivan**. I really do. And I do think we have to think of the long term, and we cannot let what has happened in our markets—I mean, this is really a disgrace when you stop to think of it. And these people that are taking things over are giving out IOU's. I mean, just plain IOU's with exorbitant interest. Then they can deduct that interest. That is really not right. Those are gambling debts. Those are not legitimate bond holders. And so I am with you.

Mr. **Dorgan**. At least on zero coupon bonds they can deduct what they did not pay, which is even more interesting.

Chairman **Rostenkowski**. Mr. Downey will inquire.

Mr. **Downey**. Thank you, Mr. Chairman.

Mr. Pickens, I want to read to you from Professor Lowenstein's study, who is someone who is going to testify before us who studied this, and I just want to read to you one of his paragraphs and if you would respond to it. I might preface this by saying that I do not believe there is either a tax or regulatory solution to LBO's, and I think the marketplace will eventually sort itself out. But I think Mr. Dorgan has put his finger on a concern that a number of us who have been advocates of doing nothing are concerned about, and that is the runup of debt.

Mr. Lowenstein is going to say that many LBO's and takeovers were well conceived and executed, and equally confident that many were not, and that many bidders would be someday forced to write off at faded prices their tulips. Tulips is defined as the big debt runup of the 1980's.

But there were $268 billion worth of merger announcements last year, and it would be foolish to overgeneralize in every direction, except, he says, "to say this: If the process is sound, if it is the magic bullet that is cutting fat and not too much muscle, why put such splendid gains at so much risk? Why is living on the thin edge an essential part of the process?"

Would you respond to that, please?

Mr. PICKENS. Well, I agree that some of the deals are not good deals. He is saying that you are taking too much risk. Is that what I am hearing?

Mr. DOWNEY. Yes.

Mr. PICKENS. I think that is exactly right, and I think that happens to be the system that we live with and that the market will punish those that have taken too much risk and they will come out losers.

I do not think there is anything that you can do as far as developing legislation to legislate against bad deals and to allow good deals to go through. But I ask you this question: I mean, who are we trying to protect here? Are we trying to protect 50 million stockholders in America? And you talked about the debt, that we are all concerned about the debt. Who is it that has the debt? I mean, I am not going to worry about, you know, the Carl Linder's of the world. Carl Linder can take care of himself, and Carl finances a lot of these, some of these transactions. He is in a lot of them. I am not saying—I mean, Carl is a friend of mine. But the thing about it is Carl Linder is a brilliant financial man. And when you take out 400,000 stockholders at RJR-Nabisco for people that invest in these deals, and they take on the debt in them, I am not going to worry about them. And I do not think you should worry about them either. And I know that some of the deals are not going to work.

Mr. DOWNEY. Well, I have always found it a little interesting that those of us in Congress should be talking to you about debt and the long term, because our track record both with respect to debt and the long term is not exactly pristine.

Can I ask you about one of the other points that Professor Lowenstein will make. He said that we should level the playing field between debt and equity so that the corporate tax structure is neutral as between the two. And he says, quite simply,

> The amount of corporate income tax should not be affected by a corporation's capital structure by whether there is more or less debt. Dividends and interest should be treated alike. The form of investment should matter to lenders and shareholders, but not to the Treasury.

Mr. PICKENS. Well, I said earlier that we do—I agree, there should be some changes. I think you are going to have to look at the total picture and not just address the debt side of the issue. You have got to address the equity side, too. But our tax laws are set up to favor debt. That is it.

Mr. DOWNEY. Mr. Simmons, did you want to say something on that?

Mr. SIMMONS. Yes, I might just add something to that. I think that you have to look overall in terms of the competitiveness issue to what the cost of capital is in various countries on Earth. I think that, frankly, when we last took a look at this in 1986, we came up with the fact that the cost of capital to a U.S. corporation averaged about 16.5 percent, which was almost double that to a corporation in West Germany or in Japan, numbers that were closer to 9 percent at that point in time.

I think what we want to come up with here is an overall integrated tax structure that helps us compete, and thus lower our overall cost of capital, which is why you see many of the debt transactions that you do in this country at the current time.

Mr. DOWNEY. I think as a practical matter, the committee faces the question and has been judicious in this process of saying, yes, it is better probably for us to level the playing field. The question is that if we level the playing field, it will come at the expense of debt and possibly some deduction on interest in order to pay for partial integration. I am not so sure personally that I think that that is a particularly good idea or an effective way to go about it. Do you have any opinion on that?

Mr. PICKENS. No. I mean, when you start leveling the playing field, you have got to think about the 50 million stockholders, too. And so it is—I mean, I have never found anybody yet that ever invested in any public-owned company that did not expect to make a profit. And I think that is exactly why they are there, and I think that is exactly why they take the offers that are made when they are premium to market offers, whether it is an LBO or in an acquisition or whatever else.

Mr. SIMMONS. I would just say that I think you have also got to remember here that those who issue debt and those who pay dividends may be very different companies. Companies who wish to retain their capital in order to be better long-term players and not pay dividends, but would have to have no deductibility on a portion of their debt when you would be actually taxing them more, and thus inhibiting their long-term ability to be a player.

Mr. DOWNEY. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

It is widely recognized that at least some of the LBO's and mergers, takeovers, have a dislocation effect for employees and communities. Would you dispute—that at least in some of the LBO's and takeovers there has been widespread dislocation and disruption of communities.

I just wonder if you would comment on your thoughts on any obligation that the target company may have to that type of dislocation and unemployment in a given community.

Ms. SULLIVAN. I would like to talk about that because I feel very deeply about it. I have seen communities almost ghosted. I mean, employees have been hurt; the towns have been hurt; the tax bases for the town has been hurt because the corporations have closed down plants because of takeovers. I mean, Bartlesville, OK, was really hurt, very hurt, with Phillips Petroleum. I know places in North Carolina that were hurt because, actually, employees and the townspeople and the stockholders are all part of a corporation. It just is not money.

You know, there is more in life than just plain money. I mean, greed is given an awful name these days. But I believe, with you—I think this is what you believe—that this is a very, very important problems.

Mr. PICKENS. The employees are always going to be a factor. What I have told the employees at Mesa is that the stockholders do own the company, and we work for the stockholders. I would like to see more employee ownership. I would like to see major corporations in America owned by the employees. And I look forward to the day when that happens, and I think it will.

But I have got to take issue with Ms. Sullivan on the Bartlesville, OK, situation. We were involved in that, and we made an offer for Phillips. We said that if we acquired Phillips, we would move to Bartlesville. I have lived in Bartlesville. I used to work for Phillips back in the early 1950's, so I know the situation very well. Phillips had cut out 10,000 employees before we ever bought a share of their stock, and today Phillips has almost exactly done what the total industry has done, which is reduce forces by 41 percent. Phillips, I think, has reduced forces like 40 percent. You might attach that to some takeover at Bartlesville. That is not so. The industry was contracting, and Phillips was a part of a large industry that was mature and was overcapitalized and should have contracted long before it did.

But just as an example to that and a comparison to that, Exxon has never had any pressure put on them—well, they have on this Valdez deal, but not prior to that. They have never had any pressure put on them to restructure or do anything else, and they reduced forces from 182,000 people to 100,000 people in 3 years. So the total industry has come down by 41 percent, and Phillips was just a part of that.

But the employees are always going to be a factor in these situations, but also, do not forget that if a company has to be restructured, or if it is in line to be taken over, whether it happens at this point or some other point, it is going to happen. Again, you have to go right back to the top. It is the leadership in corporate America that causes takeovers. If they are doing a good job, the town feels very secure; the employees are secure; and the stockholders are happy. When the stockholders are getting less than the real value for their assets, they are going to be restless. And when an offer is made, then they are going to take it. That is the way it will work. It is that simple. I do not think there are any complications to that.

But you cannot protect those towns and those employees if you have sorry management. You just cannot do it.

Mr. COYNE. Well, in the instance that you cited earlier with the Gulf takeover, that happened to be in my district, and it was 2,000 long-term employees there that were given the option of either moving to California or taking early retirement. I just wonder if we do not have some obligation, if not the target company, then certainly the Congress and legislation that would protect these people. That is why I asked the question.

Mr. PICKENS. Well, you know, in that situation, we did not try to take over Gulf. We asked them to restructure the company because it was not a good structure that they were operating in. We were not big enough to take them over and never intended to take them over. But Jimmy Lee, their CEO before a committee—I think it was the Senate Banking Committee—testified that if we had a proxy fight that Boone Pickens would win. That is what he said. And he said, "This will be horrible."

So when I testified, I said, "It will not be horrible. We will move to Pittsburgh. And there will be no closedown of Pittsburgh. We will move there and live there and make our home there." And I meant it. But we were not in a proxy fight with them. But in the final conclusion of the Gulf deal, the Gulf management had the opportunity to do a leveraged buyout which would have left Gulf in Pittsburgh. They had an opportunity to let us take it over if they thought we would win a proxy fight, and we said we would keep it there. Their third option was to sell out to Chevron, which then took it out of Pittsburgh. I never understood why—you know, the KKR offer, the deal was $87, and they took an $80 offer off of Chevron. Called me up 2 days before they made the decision and said, "If we took an LBO at $87, would you go along?" And I said, "Yes, I will. I will go along with you." They announced 2 days later they took the $80 offer.

I think that in itself shows you what kind of management Gulf Oil had. They could not take the best offer and leave everything in Pittsburgh. The company did not need to be moved from Pittsburgh, though.

Mr. Coyne. Thank you very much.

Chairman Rostenkowski. Mr. Moody?

Mr. Moody. Thank you, Mr. Chairman.

In this regard, I think what is offensive to the public about LBOs is that they see such dissimilar treatment of workers and management. I agree with most of what you gentlemen have said but I think it is offensive to see what Mr. Pickens rightly characterizes as inefficient management receiving these enormous golden handshakes while workers are given the gate. When companies are restructured and when downsizing is appropriate for market reasons, the management that supposedly brought a firm to such a sorry state is frequently given huge golden parachutes. And I find that, pretty darn offensive. I do not know if there is any comment or response necessary. But you can see why the public is irate when workers are given the gate, and management is given these lifetime sinecures.

Mr. Pickens. Because they have full control of the stockholders' assets, and they can do just what they want to with them. And so they give themselves, yes, a big golden parachute.

I mean, it is obscene, and it is unacceptable as far as I am concerned, and it is damn well unfair to stockholders. And I do not like it. And let me tell you what I have said——

Mr. Moody. The public blames the whole LBO process.

Mr. Pickens. That is right. The public gets mixed up on it because they do not like the management, but they do not like what is going on either. The stockholders rather like it when an offer is made, a premium to market offer. But the golden parachutes are, I think, sort of an insulting part of the deal, but not a big part of it. I mean, that is not a big factor.

Mr. Moody. It is just very visible.

Mr. Pickens. Let me tell you what I have said. If anybody wants to make an offer for Mesa, I said that we will take it straight to the stockholders. That is right. We will take it straight to the stockholders. We will try to get a better price, but we will take it to the stockholders. I have said that if you take over the company, then I have said that it will be the most orderly, professional transition you have ever had in your life. And I said, when you come in, I said, I will not even take the desk set off the desk, but I said I want you, if you keep me past noon, to pay me until 5 o'clock on the last day. And that is all you owe me for.

Because if that is what the stockholders want, then they don't owe me any money for me to exit the premises.

Mr. MOODY. Right. I just want to make a point. I don't think it's——

Mr. PICKENS. I agree with you. I agree exactly with what you are saying.

Mr. MOODY. It's almost a political issue. It has gotten to that level.

Mr. Pickens, you said the key is to make the management accountable and this LBO action starts to put some accountability on the backs of management that they didn't have before.

We had Kravis & Roberts in for breakfast the other morning, and they said the key to LBO's for them is to wed management with ownership.

Do you want to discuss this.

Mr. PICKENS. Sure. You know, I just said a minute ago, employee ownership is terribly important to the success of——

Mr. MOODY. They say that when they take a company over, they try to structure it so the new managers, and sometimes they are the old managers, have a significant stake in what's happening.

Mr. PICKENS. That's right. When you have a stake in it, you are going to work harder. There's not any doubt about that. I think that KKR does a good job.

Also, I mean they'll give you a lot of conversation about how they retain all the management. I don't believe that. I mean you can already see what's happened at RJR-Nabisco. I mean their managers are leaving every day down there, and there's announcements of it and all. And what they are doing, they're culling the management group and they are going to end up with the best people.

There's not any difference in it if we were coaching the football team. I mean early in the season you're going to have a lot of people come out for spring practice. But by the time you get down to September, you are down to the people that can play football is what it is. And that's what KKR is doing right now at RJR.

Mr. MOODY. Let me bear down on one area I think that really does need some attention by Congress—the conflict of interest issue.

The fact that RJR almost went to Johnson I think is pretty scary.

Mr. PICKENS. I think they came a lot closer to doing it than we know.

Mr. MOODY. And that's what's so scary. That would have been a gross conflict of interest. It would have offended, everyone in this room and it missed by a hair's breadth.

How do we structure, if at all, to——

Mr. PICKENS. I think you throw the door open. When management, I think they ought to be identified as MBO's, management buyouts, and when a management offers the stockholders a price, the door is open, the time is lengthened, and we allow other bidders to come in and see the same data that management has.

Mr. MOODY. Well, that's my question.

Shouldn't we do something perhaps to lengthen the tender period when you have a MBO.

Mr. PICKENS. I agree.

Mr. MOODY. Twenty working days is just not adequate for any group to get its act together to come in and analyze, the numbers, and find the true value of the company would be.

Mr. PICKENS. It is surprising how fast they can evaluate.

Mr. MOODY. I agree.

Mr. PICKENS. But I would say give them more time.

Mr. MOODY. Right. What's the harm in giving them more time?

Mr. PICKENS. Right.

Mr. MOODY. Would either of the other participants agree with that. If you open up the tender period for an MBO we would benefit and the shareholders would benefit.

Ms. SULLIVAN. That's right.

Mr. MOODY. The public would have more confidence in the process, and the assets would find their truer value.

Does anybody disagree with that?

Ms. SULLIVAN. This is an SEC regulation idea. I mean this is right, you're entirely right, that there should be a longer period of time, and the individual stockholders should have as much information as anybody else and at the same time. I agree with you.

Mr. MOODY. Well, there's something all three of the panelists can agree on, I'm happy to say.

Ms. SULLIVAN. It's nice that we agree on something.

Mr. MOODY. Thank you.

And on a related issue, we are going to have some testimony later today about fairness opinion fees and banking fees dependent on the outcome. That also seems to be a conflict of interest.

I'm not familiar with all the opinions, but it seems to me we ought to make sure that they are not dependent on the outcome.

Do any of you want to comment on that?

Mr. SIMMONS. That's the whole area of tender offer form which is really what you're talking about.

Mr. MOODY. Right.

Mr. SIMMONS. I know the SEC is going to come up with its own positions on this in the next week or so. And they've spent a good deal of time talking to industry about it. I think you are going to like probably some of their proposals along those lines.

Mr. MOODY. Right. It's not directly related to this committee's jurisdiction. But I think we're going to be following it closely.

Finally, let me ask for a quick reaction because time is short for me. The two gentlemen have stressed the corporate efficiency of LBO's and the push toward efficiency from increasing the debt equity ratio for the reasons that you have been discussing.

Yet the national economy is probably becoming more fragile as we move towards debt because of the threat of an economic downturn. That's not the responsibility of any given company but is the accumulation across the Nation of swapping equity for debt that makes the whole structure more fragile.

Is there anything we should do, because our job is to look beyond individual transactions, to stem that balance?

Mr. PICKENS. If I were you, I would get comfortable as to who is it that has the debt. I think once you determine that in 98 percent of these transactions, when you see where the debt is, it is not going to bother you. It is not going to bother you any more than it is me.

Mr. MOODY. You don't think the fragility of the economy is increased by these LBO's?

Mr. PICKENS. I'll say again that not every deal is a good deal. And so some deals will not make it. But I don't believe that it's the Congress of this country's position to grade deals as to whether they are good or bad deals.

Mr. MOODY. Not individual deals. I mean without looking at the merit——

Mr. PICKENS. I mean even the overall situation. I think you get comfortable when you see who has the debt.

Mr. MOODY. So we should not worry about the volume of debt, regardless of who has it?

Mr. PICKENS. That's my feeling. I would say look at where the debt is.

Mr. SIMMONS. I would very much agree with Mr. Pickens on that.

I would just say that in terms of who owns the most debt in this country, it's certainly not corporations. I mean we'd have to look at individuals, we'd have to look at the Federal Government first of all. But our own level of corporate debt which runs a little less than 40 percent of nonfinancial balance sheets in this country is significantly below that in most countries that we compete with, and it's about in line with what it has been over the last 15 years in the country.

So I don't think we should get alarmed here.

Mr. MOODY. Well, remember, those other countries that you're referring to often have a totally different relationship between government and business. They allow a lot less business cycle action than we do. And since we have given away our fiscal management tools with our huge deficit, we are almost down to no monetary policies in the way of controlling the business cycle.

I'm not so sure we want to pattern ourselves after those countries in terms of debt equity ratios of the total corporate sectors.

So I am concerned, but I'm interested that you're not.

Ms. Sullivan.

Ms. SULLIVAN. I think that this debt situation really is a crisis level. I think we have to look at it, and we have to see what is happening. I mean surely people who have a lot of money can say, okay, it doesn't make any difference. But when people don't pay interest on bonds, then who is paying for it will be eventually the taxpayer.

Look at what happened to the S&L's, who is going to pay for that?

Mr. MOODY. The taxpayer.

Ms. SULLIVAN. The taxpayers. Right.

Mr. MOODY. Thank you very much, Mr. Chairman.

Thank you, participants.

Chairman ROSTENKOWSKI. Mr. Ford.

Mr. FORD. Thank you very much, Mr. Chairman.

Mr. Pickens, Mr. Simmons, and Ms. Sullivan, thank you very much for your testimony.

I would like to ask whether there is an area or industry that maybe should be exempt from any leveraged buyouts? And I'm basically speaking of the airline industry. We know that we have only eight or nine domestic-owned carriers, and, given the public's need for transportation, we've witnessed since the deregulation of the airline industry some problems there. I guess I'm basically speaking of one that has been publicized in recent weeks, Northwest Airlines.

You see management is saying no to this sort of a hostile takeover. There are the employees with the airlines, and since Northwest merged, I guess a few years back, with Republic, Their debt has never exceeded over $130 or $140 million. There's substantial equity in the company.

Mr. Pickens, you mentioned earlier that you favor to spinoff. In my reading about the company, there is nothing spinoffs in Northwest, with the exception maybe of gates, airplanes, and maybe forcing some of the employees out of the work force. But when there are no spinoffs, and there is a great public demand of air transportation, and we are talking about greater equity versus debt, a company that has not fared very well—I guess all of the assets have been in place but I don't know about the profits for the shareholders, is there any need to protect an industry, such as the airline industry? Should we discuss or try to look at the leveraged buyouts in certain industries?

Mr. PICKENS. You know, when I go back and look, and I'm no expert in the airline industry and I've never even looked at any acquisition in the airline industry. But when I go back and look at it from just a person that does a heck of a lot of flying, that when you deregulated the airline industry, you dropped the price to the passenger, and we took them out of the bus terminals and put them in the air terminals. And more people started flying.

And therein we have a real congestion in our airports, and we're talking about all kinds of things. Denver, you've noticed, and I don't remember—that thing was voted on yesterday. I'm sure it probably passed. But we are looking at bigger and bigger airports in different places.

I think we've got tremendous problems as far as the airline industry is concerned. It's just sorting out the traffic.

But as far as having concerns, I don't have concerns about—and when you say Northwest Airlines, that I'm supposing that whoever made the offers for Northwest Airlines expects to operate them, just as Northwest Airlines did. I see it more from a standpoint if it's a good deal for the stockholders, it must be a good deal. Knowing that every deal isn't a good deal, but basically that's the way I come up on it.

As far as the change in who runs the company, I see that as a, you know, it's going to be operated with the same people.

Mr. FORD. I understand that on management. But the debt going from $125 to $350 million, or whatever the number might be, is two or three times the amount of debt that the company has experienced in recent years.

Mr. PICKENS. But, see, that goes right back to who is it that has the debt. I mean the common stockholders have been bought out.

They are not carrying the risk. The risk has been shifted to another group. Who is that group?

Mr. **Ford**. But how does it impact communities? I happen to have one of the hubs of Northwest in my area. The employees and management are all saying that the spinoff will cost the airlines half of the jobs, half of the flights, not just part of it. I mean just looking at it from——

Mr. **Pickens**. I don't know. But I know management is very good at getting this story out. I mean that's part of the defense.

When we made the offer for Phillips, and we said we would move to Bartlesville and live there, make our home there. All we were talking about is who is going to run the company. Because the other people, the other 25,000 people are going to work just like they had in the past.

So, here you've got a situation where maybe management has unfairly described what's going on. I don't know.

I yield to Mr. Dorgan a minute.

Mr. **Dorgan**. Will the gentleman yield? Thank you.

Let me observe, with respect to the Northwest situation, the additional debt that would be imposed in the event of a takeover. That company, according to most experts, would incur another $300 million a year in annual interest costs.

Now, as you look at that company, there is only one way to handle that for that company, it seems to me, and that's to pass it on through increased ticket costs, or to take a look at the areas of the routes that are less densely populated. That concerns a whole lot of travelers in my part of the region.

So when you take a look at one side of the equation, maybe somebody that gets a higher stock price in the short run, yes, those folks benefit.

The second part of the story that's never told is there are a whole lot of folks out here that are not going to benefit. They, in fact, are going to pay an enormous price for this. Somebody has to pay for the $300 million.

Mr. **Pickens**. See, that could be a reduction in dividends as far as that goes. I don't know what Northwest's dividend is. But you no longer have common holders that you have to pay a dividend to.

Let me tell you, the people that I've seen that have worked on these deals evaluate the assets very well, and they understand the cash flow and they know what has to happen.

But it doesn't mean that a company has to go down in size. The company can go up in size.

Mr. **Dorgan**. Absolutely.

Mr. **Pickens**. I mean you're just talking about who is going to run the company.

Mr. **Dorgan**. There's no way on God's green Earth that you are going to saddle a company like Northwest with $300 million a year additional in interest costs, and have that be beneficial to the people it serves. There's no way that's going to happen. You tell me how.

Mr. **Simmons**. That's not necessarily true though. I mean what you have to——

Mr. **Dorgan**. Will you tell me why it is not true?

Mr. **Simmons**. I'll tell you exactly why it's not true. Because what you have to do here is look at the fact that somebody is going to own $2.5-billion plus of securities in Northwest Airlines going ahead. Somebody has made a judgment that Northwest Airlines going ahead is going to at some point provide them with a significant capital gain because of that investment.

Mr. **Dorgan**. That's not true at all. You know that. You know better than that. Somebody has made a judgment that the assets are undervalued. They have not made a judgment about the continuity of the company.

Mr. **Simmons**. Somebody is going ahead, and they're making a judgment that both the interest will be paid and that the equity owners will make a profit.

They've got to build something, as Mr. Pickens said before, that's going to work in the future, not just works today. They are on the line for that.

Mr. **Dorgan**. But I like to think there's a question of the operation of the company. You're talking about asset values, and the question whether somebody can take it apart and make money by reselling the assets.

That's a legitimate issue. But the other side of the coin is significant costs for a whole range of other people. And they are forgetting that, in my judgment.

Mr. **Ford**. One of the reasons why, Mr. Pickens, I raised the question earlier as to whether or not we should protect certain industries, the airline industry is one, whereby if you talked about the spinoffs, you are talking about some bad deals. When you talk about leveraged buyouts in the airline industry, and you realize that we only have a few major domestic-owned airlines we risk selling off the assets, narrowing the work force and cutting back flights in an industry in which deregulation might have already brought about minimal flyers in this country. At the same time, to cut off, shut down or narrow the work force in an airline that we know that we will readily have a shortage in rural areas, southern areas in this country that many of the carriers currently do not service.

Mr. **Pickens**. But then you're getting down now to how much do you want to subsidize on uneconomic routes, say? I don't know. I mean I don't know what you—you know, what you have heart for that.

You know, I'm going to always look at things from an economic standpoint because I found in my experiences that if you don't, you eventually will have to. It will finally come down to economics at some point. Because if it's not, somebody is carrying somebody else.

So if you are going to subsidize rural areas with air transportation, you are going to have to decide what you're willing to pay for.

Mr. **Ford**. Yes; but you must go beyond the shareholders and those who put these profitable deals together and, at some point, focus on the consumer. The public's interest has to play in and be a major factor here.

Mr. **Pickens**. It has to be a factor. There's no doubt about it. And I'm not saying to you, that any suffering that people would have, whether it would be customers or whether it would be employees, they have to be considered.

But you can't change the system that we operate under, who is it that owns the company is the question. And it's the stockholders that own it. And if there is an offer made to the stockholders, they have a right to take it because they bought it, they took the financial risk.

And if it is not going to be that way, somebody needs to tell. I mean it should say on the certificate that you may have an offer made for you but, for some reason or other, it may be turned down because it's not considered to be in the public interest.

I mean it's sort of like that deal that's on the cigarette package. I mean you take these at your own risk.

But I think, you know, we've got to change the system if we're going to, and certainly alert the stockholders to it because there is a financial risk here.

Mr. **Ford**. One final point. From a tax policy standpoint, whether you look at the junk bonds or you look at overall debt treatment under the Tax Code, what the corporate raider or the new shareholders and the owners are able to do is write it off the interest on the debt.

But what we're talking about here is protecting the public. The public does have an interest here. And, therefore, we're looking at leveraged transactions and debt treatment under the Tax Code at this very moment because of policy concerns.

Mr. **Pickens**. But the public can write off interest costs just like any of the other ones you mentioned.

Mr. **Ford**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Brown.

Mr. **Brown**. Thank you, Mr. Chairman.

Mr. Pickens, we appreciate you coming this morning. Your statement talks about concern over making hostile takeovers heavily taxed or subject to less favorable treatment than friendly takeovers. And you point out the problems with competitiveness for the American economy if you should prevent hostile takeovers.

Share with us your view on what impact the potential of a hostile takeover has in controlling management salaries and benefits.

Mr. **Pickens**. I may not understand the question here.

Mr. **Brown**. Well, this committee has focused, as you know, over the last 4 or 5 years, a great deal on management salaries and benefits in section 89 of the Tax Code and so on. Some of us end up feeling that one of the ways you make sure that management compensation is competitive and not excessive is to preserve the right of the shareholders to sell the company or to change management.

I guess my concern is if you outlaw hostile takeovers, you make it very difficult for the shareholders to come in and either change management——

Mr. **Pickens**. Oh, you can.

Mr. **Brown** [continuing]. Or to reduce benefits they may consider excessive.

Mr. **Pickens**. See, I don't think that takeovers should be identified as hostile or friendly. I mean it's an offer made. It's not different than if you had your house and you didn't have it up for sale, but somebody knocked on the door and said I'll pay you $100,000 for it, you don't consider that to be hostile. I mean that's an offer is what it is.

Now you have an option to decide whether you want to take it or not. You may say, well, you know, I wouldn't sell for $100,000, I wouldn't sell for $500,000. Don't make me any more offers. That's final.

But here you, the owner, have an opportunity to make a decision as to whether you want to take the $100,000 or you want to turn it down, and continue in corporate America managements and all of us that are running these companies. I mean we're not, you know that we all ascend to a position in a publicly owned company where we become—it's almost like your private fiefdom.

You are, you know, with certain limitations, you can make just about whatever decisions you want to make. And there has to be an accountability in every system. The accountability in this system is the owners, the stockholders they want that should keep managements accountable.

I don't see anybody else to do it. You can't do it. The stockholders are the only ones that can do it. And so the stockholders have to have the right to weigh any offer that is made for the company, either take it or turn it down. With that, we have got to develop—another improvement in our system is that you can get rid of management. Today you can't get rid of them.

A football coach with a 1 and 10 record gets another year, and that's it. And then he's gone. And you have to stand for reelection every two years. And if you don't win, you're gone. In corporate America, nobody stands for reelection, we don't stand for reelection. I mean it's a sham. You send the proxy material out, but, you know, I mean everybody votes for you. Some don't like you that vote for you. But, by gosh, how would you like to have it where you get to count the votes? We count the votes. They come in to us, and if we don't like how somebody votes, we call them up and tell them that, call them up and say, hey, look, you know, you don't want to vote against me. And more than unlikely, oh, well, it was a mistake. Some clerk did that, you know, and so, sure, send me another proxy card.

At Mesa, we are the only company in America with a true confidential vote. Yesterday, we had our annual meeting. And at that meeting, I didn't know whether I had a quorum or not until I got there. The outside auditors—not our regular auditors, but outside auditors that we don't use except for this one. Peat Marwick, this is the only job Peat Marwick does for us. We did have a quorum and we did vote and all. But we did not see any of the votes. We cannot go back and look at them later. We cannot find out who was against us. It's truly a confidential vote. You need that in corporate America for stockholders to have the right to do it.

There has to be some method. You can throw the buggers out if they're doing a lousy job.

Mr. **Brown**. In effect, outlawing hostile takeovers is a management incumbency program.

Mr. **Pickens**. That's exactly right. That's exactly right. If you want to entrench them in, fix it so somebody can't make an offer for them.

Mr. **Brown**. Thank you.

Chairman **Rostenkowski**. Mr. Pickle.

Mr. Pickle. Well, thank you, Mr. Chairman, and Mr. Pickens, it's good to have you before our committee again.

Mr. Pickens. Thank you, Mr. Pickle.

Mr. Pickle. I didn't get to hear the testimony of Mr. Simmons and Ms. Sullivan, but I will read your statements. We are glad you are here.

Ms. Sullivan. Thank you.

Mr. Pickle. Mr. Pickens has been before our committee before. I don't know, Mr. Pickens, whether you were the original sin or the first fresh breath of air in corporate America——

Mr. Pickens. Could I answer that? [Laughter.]

Mr. Pickle. You are a lively person, lively witness, and a lively businessman and a successful businessman. I think the members will recognize your sincerity in testifying although we may have some differences in approach.

I read your testimony, and it seems to me you are saying to us that we ought not to do anything, just let the market take its course

I guess my question would be, should the Congress do anything in this big question of LBO's, mergers and acquisitions?

Mr. Pickens. Let me address LBO first. And what I would say there is that any time management makes an offer to the stockholders, I would give—it's then an open auction. The company has been put on the block. Anybody that is a qualified bidder has the opportunity to look at the information that the management did, which means extend the time.

If management is going to make an offer like RJR and Nabisco did, $75 a share, and the board of directors did come around and did open it up to an auction and did get $109 for it. And with that that the time should be extended and any legitimate bidder should have the opportunity to see it. I think that would be good if you could do something in that area.

As far as the other, I would leave it up to the market. I don't think any of us are wise enough to be able to grade good transactions and those that are not. I think the market will absolutely penalize the bad transactions.

Mr. Pickle. From your testimony, it looks like you're saying that the only thing that Congress really ought to do would be to eliminate this double taxation on dividends.

If we did that, would that stop the LBO's, would that stop the take overs?

Mr. Pickens. No. When you say LBO, there are not nearly as many LBO's as there are just offers for assets. Those are going to go on any time that the market price is substantially below the real value of the assets.

I mean in a public company, that is an open invitation for it. And, see, what changed this whole game was junk bonds, was the ability for somebody to go out and raise huge amounts of money to buy assets. That's it.

So, once that key went into the lock, it was all unlocked, because when you started to sit around and see companies that were selling at one-third of their assets value, why it was an absolute cinch for somebody to come in once they had the money to do it.

Mr. **Pickle**. In our hearing 3 years ago, we concentrated on the junk bond issue. We didn't make much headway. We got a few improvements. We did eliminate the greenmail aspect of these big mergers. And there are other questions left open on the junk bond issue.

The next witness, Mr. Sterling, I think, will comment on that. And I am glad he can testify.

But it seems to me that you're saying that we ought to eliminate dividend double taxation, not fool with interest; let that alone. You have added that we ought to give them a little more time on the consideration of a takeover. I guess I'd give them a little more time for the stockholders to be agonizing or the management to be agonizing. But you do make the recommendation

But it seems to me, Mr. Pickens, either Congress looks the other way and does nothing, and just say, well, let the market take its place or we try to find some kind of an answer.

Now, it concerns us when the RJR deal would result in some $4 or $5 billion in fees that we don't think goes for production, but that's just one aspect of it. And we worry about the junk bonds and the use of debt versus equity.

We have to decide do we do nothing? And we have to decide if we take your position, we don't tax you twice on dividends, we don't touch interest deductions, and we give a little more time to consider offers.

Now, do you think that's enough for Congress to do?

Mr. **Pickens**. I do. I mean, look at the RJR deal. How did we, the people in this country come out in the RJR deal, not stockholders, we the people?

Well, huge taxes were paid in that. I mean, when they paid $25 billion for RJR, I'm sure there must have been something 3, 4, 5 billion dollars worth of taxes.

Mr. **Pickle**. Are these big promoters going to take over these companies?

You would have to assume there is not a selfish ounce of blood in their body; that they just said management is overpaid and we are going to correct that, and we're going to——

Mr. **Pickens**. No; I don't think that was it.

Mr. **Pickle**. We therefore are going to step in like the Lord had waved a wand on us, and we are going to put a stop to this. I don't believe that corporate America believes that.

Mr. **Pickens**. I don't either.

Mr. **Pickle**. Or thinks it.

Mr. **Pickens**. I don't either. They're in there for the same reason any other business man who goes to the office every day, to make money. That's exactly what they're doing.

Mr. **Pickle**. Nothing wrong with that. It's obviously a complex question about what we can do because we wouldn't be having all these hearings. We're trying to find some kind of answer.

The administration now is backing off and says we don't think we ought to do anything. They've almost turned 180 degrees it looks like. Now, when they do that, then there's not as much encouragement for us to try to find some kind of a simple answer. If we leave it alone, then we run the risk millions of people are going to get hurt in the process, and it's a tough decision for us.

Now, I don't know that it's enough to say we were going to give dividend relief. I'd give dividends, elimination of double taxation on dividends if we could also do something about interest. But every time you touch interest, all of America gets nervous, and I don't blame them for that.

So we are just trying to find an answer.

Mr. **Pickens**. Well, see, I compliment you for the hearings. I'm glad you had the hearings because I think this bothers people in America, what's going on.

I mean you're talking about huge dollars. They pick up the paper and see where somebody made a $50 million fee off of something for an investment banking fee. They wondered how they did it, how does this guy get it?

And then you read some reporter says that the guy was 28 years old or something like that. Well, that's absurd. I mean that's not true. I mean that's just as incorrect.

But people do get big fees. Why are they getting big fees? Again, go back to the original, the symptom of the problem is corporate America's leadership has let you down is what it is.

If the value of the assets are properly reflected in the marketplace, there would be none of this stuff going on. And when you get through with it, when you finally—I don't mean your hearing—but I mean when we get through restructuring corporate America, all of us, and we're all a part of us, that when you get through with restructuring corporate America, let me tell you, it's going to be a lot more efficient and a lot more productive situation than we've had in the past.

Chairman **Rostenkowski**. Mr. Levin.

Mr. **Levin**. Just a brief question, Mr. Pickens.

Are you worried or not about the trends today in America and long-term investment? Are you concerned about——

Mr. **Pickens**. No. You know where I come from. I mean I've been in the oil business since 1951 and built the largest independent oil company in the United States. You know, I have people even say that Ben Pickens is a short-termer.

I personally owe more money than I have ever owed in my life, and I still owe for my stock in Mesa. I mean here I'm 61 years old next week. So I mean you've got to call me a long-termer if I am willing to make that kind of commitment.

No; I'm not concerned about it. I'm not concerned about research and development. I think that good managers have the proper level of R&D. I think good managers manage for the short term, the intermediate and the long term. They're good managers. They are abiding what I believe that all of us should do in our fiduciary responsibility, do the best we can with the capital we have available to us.

Why does everybody want to get in our markets on America? Because our system does work, it works. Not perfectly, but it does work.

Chairman **Rostenkowski**. Would you say, Mr. Pickens, there's a little bit more security here than there is elsewhere?

Mr. **Pickens**. Well, there is more security here because of our system, because what happens right here in Washington gives people lot more security.

Chairman **Rostenkowski**. I would like to see we, the people, being citizens of the United States—not we, the people from some foreign land investing in here and spending all the money.

Mr. **Pickens**. I'm kind of liking that discussion. I mean I agree with you. I don't like the way we don't have a two-way street. I think we have been somewhat naive in allowing some countries to come in here and their businessmen to come into this country and just kind of, you know, okay, we are glad to have you. I think we have been too easy.

Of course, I have a conflict of interest on this part of the discussion, for sure, because of my involvement in Japan.

But I do believe that we are investing for the long term in this country. I think that you are going to find—somebody asked me, said what would be the fix for corporate America if you had one wish? I said that would be that we would retire every CEO in America that was 55 years old and older, including me, and turn it over to another generation.

I think that actually my generation in corporate America has done a pretty lousy job on leadership.

Ms. **Sullivan**. Couldn't I have a wish? I wish we would handle junk bonds. I mean that's the key. Mr. Pickens said that.

Now, look, there is a real simple way to do it. We have people, we have companies that rate bonds. A rated bond is good legal tender. But we have these junk bonds. Really it's funny money. It's not worth anything. It really isn't, and that is the key. That's because people are going in, taking over these companies, not with their own money, but with borrowed money, and the other people out there in the street changing the whole idea of our system into a casino. And the taxpayers are going to have to pay these gambling debts.

Now, I think that that junk bond business is the first thing that should be hit, and that's where you can do something.

Mr. **Levin**. Mr. Chairman, if I just might ask one last question of Mr. Pickens.

If we produced lousy managers, as you put it in our system, why do you think the next generation will do any better?

Mr. **Pickens**. Well, I guess because I'm an optimist.

Mr. **Levin**. Any other reason?

Mr. **Pickens**. Let me say this so it doesn't go totally in the record that corporate America's leadership is all bad. I don't believe that for a minute. I think we've got some great leaders in corporate America, and I think we've got some that are pretty lousy.

Mr. **Dorgan**. Would you yield? Now I'm very confused because, just a minute ago I think, you said all CEO's ought to be replaced, and our problem essentially is the management of corporate assets in America.

Mr. **Pickens**. And now I'm saying some of them are good.

Mr. **Dorgan**. Now you're saying something different.

Mr. **Pickens**. Well, I'm one of the good ones. [Laughter.]

So I'm ready to say take me out, too. I'll go out with the—I think we've got 80 percent of them that could do a better job than they're doing. And so I'll take out the 20 to get the 80 is what I'm saying. I'm part of the 20.

Mr. **Dorgan**. The overwhelming majority are——

Mr. **Pickens**. Yes, I think really. But what happens is where we lost in the system its accountability is that stockholders did not do their job as they should have. They are the ones that require the accountability of management, and they broke down on their responsibilities.

And so that is coming back. I mean, look what happened to the Honeywell deal this week. I mean the public pension funds went in and actually took—voted against the Honeywell management on some very key points at their annual meeting. And I think that's terribly important that stockholders have to get involved, and they will make management accountable.

Mr. **Dorgan**. Thank you.

Chairman **Rostenkowski**. Thank you very much. Thank you for joining us this morning.

Ms. **Sullivan**. Thank you.

Mr. **Simmons**. Thank you.

Chairman **Rostenkowski**. Mr. Sterling, Mr. Lowenstein.

Welcome to the committee, gentlemen. Mr. Sterling, I don't have to welcome you. You've been here before.

I think you know what our form is. We would like for you to summarize your statements if the statements are longer than the given time allocated. We're pretty loose here with the time as long as you make it interesting for us.

So, having said that, Mr. Sterling, if you would identify yourself, and then Mr. Lowenstein, after Mr. Sterling has given his testimony, please identify yourself for the record before giving your testimony.

STATEMENT OF JOHN L. STERLING, ESQ., PARTNER, JONES, DAY, REAVIS & POGUE, CLEVELAND, OH

Mr. **Sterling**. Mr. Chairman, other members of the committee and staff, good morning. My name is Jack Sterling. I am a Cleveland based partner in the law firm of Jones, Day, Reavis & Pogue.

Except for a 2-year period, I have practiced tax law with Jones Day for over 20 years. From mid-1983 to mid-1985, I served as special counsel to the Joint Committee on Taxation.

I am pleased to be here today to discuss a few of my thoughts and a specific proposal with you.

I am not here today on behalf of Jones Day, or any of its clients. The statements I make are my own. Furthermore, they are the statements of a tax lawyer and not necessarily those of an economist, an investment banker, or the chief executive officer of a corporation.

For present purposes, I have four main thoughts.

First, as we all know, our present tax system encourages taxpaying corporations to raise a given amount of new capital by issuing debt rather than equity and to replace existing equity with debt in a restructuring.

Because of the tax laws, I believe that the capital structures of many corporations consists or should consist of a higher percentage of debt than would be the case in the absence of a tax law.

Second, in my judgment this tax-induced overleveraging is not healthy for the economy. For example, because of the nontax consequences that can befall a corporation which defaults on its debt obligations, a debtor corporation, to avoid such a default, may have to take steps it would not have to take if it did not have those debt obligations. These steps might include selling off assets, raising prices, cutting costs by reducing R&D expenditures or laying off employees, or expanding at a slower rate than would otherwise be the case.

And an overleveraged company obviously will more likely have to take such steps than one which is not so highly leveraged.

Third, because of the first two points, I would very much like to see our tax laws changed so that corporate debt and corporate equity are treated as equally as possible. That would eliminate or reduce the current tax subsidy provided for corporate debt. I think that reducing the tax reasons for overleveraging and hence reducing excessive leveraging itself would be a very healthy development.

Fourth, I assume that we are unlikely in the near future to move very much in the direction of treating debt and equity equally for tax purposes. That is only an assumption. It may be wrong. I hope it is. But, for the moment, it is my assumption.

Given all that, I think we should try another approach to reduce the tax subsidies for excessive corporate debt. My approach, a simple one, would be to amend the code to treat a certain kind of financial instrument, junk bonds if you will, as equity rather than debt.

To me, a primary distinction between debt and equity is the degree of risk undertaken by the holder of the instrument in question. The more risk assumed by the holder, the more the instrument involved looks like equity.

How can we measure this risk? By looking to the return demanded by the holder. If the risk is high, so will be the return demanded.

My proposal then is that the code be amended to provide that any purported corporate debt instrument which, at the time of its issuance, has a potential yield to maturity which is too high to be characterized for tax purposes as equity. A potential yield which was more than, say, 140 percent of the applicable Federal rate would be too high. And that's it.

To me, one of the appeals of the proposal is that the market would determine the instrument's yield and, therefore, whether it should be treated as debt or equity for tax purposes.

As with most tax rules, my proposal would need to be crafted carefully so that it could not be circumvented. For example, some antiabuse rules might be required for use in those cases in which an instrument's yield to maturity could not be easily determined at the time of this issuance.

My written statement discusses that subject in more detail.

Some might object to my proposal on the ground that it would hit cases which were not intended to be hit. For example, if it were applied to small businesses without established credit, it might hamper their ability to raise debt capital. To the extent you are worried about that or have other concerns, you could limit the universe to which my proposal would apply.

For example, you could provide that the rule would apply only in cases where the purported debt obligation was issued as part of an issue of more than, say, $25 million. However, attempting to apply my proposal only in cases involving hostile acquisitions would be difficult technically and, in my mind, an inappropriate use of the Tax Code.

Furthermore, the theory behind my proposal—that if it looks and acts like equity, it ought to be treated as equity—is applicable regardless of the use to which the proceeds of an issue of obligations are to be put.

In the takeover area, the proposal would reduce the ability of a corporate raider to issue tax-subsidized junk bonds to finance a hostile raid on an only modestly leveraged target at a substantial premium.

And a corollary, it would reduce the need for the target and the ability of the target to issue tax-subsidized junk bonds of its own in a restructuring designed to fend off that raid.

My rule would be intended to apply equally and neutrally to both sides. The benefit of the rule would be that it would reduce the tax benefits of excessive corporate leveraging in the takeover area and elsewhere. It should, therefore, reduce excessive leveraging itself and, as a result, the potential adverse economic consequences that such excessive leveraging could lead to.

I thank you.

[The statement of Mr. Sterling follows:]

Testimony Before The House Committee On Ways and Means

By

John L. Sterling

Regarding

The Tax Policy Aspects of Mergers and Acquisitions

May 17, 1989

Introduction

I am a partner in the law firm of Jones, Day, Reavis & Pogue. I have been practicing tax law for over twenty years, and I specialize in, among other things, mergers and acquisitions and their Federal income tax consequences. From mid-1983 to mid-1985, I served as Special Counsel to the Joint Committee on Taxation.

I am not here today to testify on behalf of Jones, Day, Reavis & Pogue or any of its clients. Furthermore, I am a tax lawyer. Thus, while I am a believer in the free-market system, I am not prepared to testify as to whether any particular large merger, acquisition, buyout, or restructuring has or has not been beneficial to the country. Nor am I competent to testify as to whether the securities laws need some modification. Rather, I am here to express my personal views on certain aspects of the Federal income tax laws as they relate to the subject under discussion and to offer a proposal to modify them. My proposal is not intended to favor either corporate raiders or those defending against corporate raiders. It is intended to apply equally and neutrally to each, as well as to corporate issuers of obligations issued in contexts not involving an acquisition of any kind.

Statement

Corporate America raises large amounts of capital in two main ways -- it issues debt instruments and it issues equity, or stock, instruments. Yet, as we all know, the Federal income tax laws treat the two main forms of capital very differently. A major, but not the only, difference is that interest on debt instruments is generally deductible by the corporate issuer whereas dividends on stock instruments are not. It is these principles which explain, to a significant extent, why a corporate raider prepared to leverage to the hilt can offer the shareholders of an only modestly leveraged tax-paying target corporation a substantial premium over market for their shares. And it is these principles which explain why the target may be able to fend off the raider by undertaking a heavily leveraged restructuring.

Because of the deductibility of interest, it seems to me that, purely from a tax perspective, it is generally to a tax-paying corporation's financial advantage to raise any given amount of capital by means of a debt, rather than a stock, offering and to replace existing equity with debt. (Non-tax-paying corporations, those with tax losses, are generally better off from a tax perspective issuing preferred or other forms of stock instead of debt. Because of the inter-corporate dividends received deduction, stock, particularly preferred stock, can be issued as a relatively inefficient form of tax benefit transfer.) Furthermore, I believe that that tax advantage for debt can be so significant that many corporations (including corporate raiders and, to defend themselves, their targets) which in the absence of a tax law would capitalize themselves with "adequate" layers of equity, because of the tax law, are or should be capitalizing themselves with substantial amounts of debt instead. That is, the current tax laws encourage a higher level of leveraging by tax-paying corporations than would exist were there no tax laws. But because of the non-tax consequences that can befall a corporation which defaults on its debt obligations, and because of the steps (e.g., selling assets, cutting research and development expenditures, laying off workers, and expanding more slowly than would otherwise be the case) a corporation may choose or need to take to avoid such a default and its consequences, I do not believe "excessive" leveraging to be desirable as an economic matter. To the extent the tax laws are responsible for excessive leveraging, they should be changed.

Since issuing debt and issuing stock are both ways of raising capital, in a perfect world I would strongly favor a tax system that treated the two as similarly as possible. Theoretically, that could be done in a variety of ways, including generally by allowing the issuer to deduct the same percentage (if any) of both interest and dividends and/or by allowing the holder a tax credit based on taxes paid by the issuer on some part or all of the income earned by the issuer to pay the interest or dividends. The idea behind such a system, which could but need not produce full integration, would be to eliminate or reduce the impact of the tax laws on a corporation's decision to issue debt or stock to raise a given amount of capital or whether to restructure itself by replacing equity with debt.

However, on the assumption that, for whatever reason or reasons, we are not yet ready for the perfect world, I think another approach is called for.

Any regime, like the current regime, which treats debt and stock differently puts enormous pressure on definitions (that pressure is another reason for favoring a system treating the two as similarly as possible). That is, before we can know whether a particular instrument is to produce the tax consequences of debt on the one hand or equity on the other, we need to know whether that instrument is properly to be characterized for tax purposes as a debt instrument or an equity instrument. Our tax laws have long struggled, without a great deal of success or certainty in many cases, with that characterization question. In many cases, the law today essentially permits the issuer to elect between the two.

I am here today to make what seems to me to be a fairly simple and modest proposal regarding the characterization question. While my proposal, if adopted, would not solve all the problems arising under the current laws, it is clear to me that it would substantially reduce the tax subsidy for excessive corporate leveraging. It would also be less complicated than some of the fixes proposed by others.

In my view, a basic distinction, if any distinction is to be drawn for tax purposes, between debt and equity instruments ought to focus on the holder's risk of loss. The more likely it is that holder of an instrument will receive his principal back, with a fair return, the more the instrument looks like debt. On the other hand, the riskier the instrument, and the more likely its holding is to lead to a loss of the holder's principal, the more the instrument looks like equity, which, after all, is the capital theoretically at risk. How can one measure this risk? By looking to see what potential yield to maturity the holder demands before he will acquire the instrument from the issuer. For example, pure common stock, the riskiest investment one can make in a corporation, has an unlimited potential yield to maturity since it shares in the benefits of growth and appreciation, even if it pays no dividend. If the prospective holder perceives a substantial risk of loss, he will demand, as a condition of assuming that risk, a greater potential yield to maturity than he would have demanded if he had perceived a lower risk of loss. And this is so even if the holder's maximum potential yield to maturity is fixed and does not depend on how well or how poorly the issuer fares.

My proposal, then, is that the law be amended to provide that a purported debt instrument (for example, an instrument labelled "debt" which provides for a fixed stream of payments) will be characterized in full for tax purposes as an equity instrument if, at the time of its issuance, its potential yield to maturity is "too high", i.e., is more than a specified percentage of the then applicable Federal rate. What that percentage should be would essentially be a matter for Congress to determine, but thought could be given to setting the rate at, say, 140 percent, or some other percent, of the applicable Federal rate at the time of issuance. The beauty of the proposal, if I may be so bold, is that the market would determine how risky the instrument is and, therefore, whether it should be viewed as debt or equity for tax purposes. Furthermore, the proposal would apply equally and neutrally to all industries.

The proposal, which the Treasury probably already has the power to adopt if it wished without any statutory amendments to the law, would work quite well if an instrument's potential yield to maturity were easily determinable at the time of issuance in every case. Unhappily, however, it may not always be. Therefore, some support, or anti-abuse, rules may be necessary. These rules could include rules to the effect that a purported debt instrument would be characterized as equity, or stock, if: (1) it is convertible, exchangeable, or redeemable for property other than cash; (2) it is part of an investment unit which includes an equity interest or an option to acquire an equity interest; or (3) the amount or timing of payments under it is contingent on how well or how poorly the issuer fares or similar factors. Further fine tuning, and other anti-abuse rules, might also be considered. The appropriateness of any particular anti-abuse rule (including each of those listed above) would depend, among other things, on (i) whether it would cause obligations to be treated as equity which Congress would not have wished to be so treated, (ii) how accurately a particular obligation's potential yield to maturity could be determined in the absence of the rule, and (iii) what exemptions from my proposal might be adopted (see below).

Under my proposal, the tax "common law" rules would continue to apply. That is, an obligation could be classified as equity under the tax common law even if its potential yield to maturity were not "too high" and even if the instrument were not to be characterized as equity under one of the anti-abuse rules.

Some may argue that my proposal would sweep too broadly, causing debt which was not intended to be characterized as equity to be characterized as equity. Small or new businesses without established credit, for example, might be adversely affected by such a rule. Furthermore, the impact of my proposal would not be limited to purported debt instruments issued in connection with a leveraged acquisition, buyout, or restructuring, as some might wish.

Such concerns could be addressed, if Congress so desired, by limiting the universe to which the new rule would apply. For example, it could be provided that the new rule would apply only if the purported debt instruments in question were part of an overall issuance of more than, say, $25 million, or some other amount, of capital. What that amount should be would depend in part on how strict a set of anti-abuse rules may be enacted as part of my proposal. Presumably the stricter those anti-abuse rules are, the higher that amount could be. If $25 million were the amount, the proposal would be inapplicable to the great majority of corporations.

Other universes could be considered. In my judgment, however, limiting, or attempting to limit, the universe to debt incurred in connection with a hostile takeover would be both very difficult technically and dubious tax policy. The theory behind the proposal -- that if it looks and acts like equity it ought to be treated as equity -- is equally relevant whether the proceeds of the instrument in question are to be used for a hostile acquisition or otherwise. Furthermore, tax stimulated over-leveraging can occur outside the acquisition context. Finally, my purpose in making the proposal, as noted above, is not to penalize hostile acquisitions or any other kinds of acquisitions. It is simply to do a better and more predictable job of distinguishing corporate debt from corporate equity in a range of cases and, more importantly in my mind, to reduce the likelihood that the "excessive" corporate leveraging encouraged by our tax laws will lead to adverse economic consequences.

I do not view my proposal as in any way inconsistent with a belief in the free-market system. It is not intended to deter acquisitions generally, and it is not intended to interfere with the raising of capital by America's corporations. It is a tax proposal only. In the takeover area, it should have the effect of reducing the need of corporations to restructure or recapitalize by issuing "junk bonds" as a defense against a raider who, because of the tax subsidy, is prepared to issue "junk bonds" of its own to help finance the raid, thereby helping to fund the premium over market the raider may be offering. It should also make it unnecessary for any corporation to excessively leverage its capital structure as a defense to the possibility that it may some day be a target. I think such results would be very beneficial.

Chairman Rostenkowski. Thank you, Mr. Sterling.
Mr. Lowenstein.

STATEMENT OF LOUIS LOWENSTEIN, SIMON H. RIFKIND PROFESSOR OF LAW, COLUMBIA UNIVERSITY, NEW YORK, NY

Mr. Lowenstein. Mr. Chairman, thank you.

I am professor of law at Columbia University. For 20 years or so, I practiced law in corporate and securities work in New York. And for about a year and a half, I was president of Supermarkets General Corp., based in New Jersey.

In substantial part, I agree with Mr. Sterling. I think that the LBO takeover process does have a substantial skew in it stemming from the tax laws. I regard that skew as dangerous for the economy as well for a substantial number of companies.

Unlike some of the prior witnesses, I don't regard the present situation of tax laws a state of nature. There are no particular reasons why that tax structure cannot now be reexamined by this committee.

In looking at the extent to which transactions are driven by tax considerations, it seems to me the answer is fairly clear. We have companies which, simply by flipping the capital structure, without being taken over, companies like USG, Kroger and many others, suddenly and quickly increase in market value 40 to 50 percent. And the reason is not hard to find. Dollars that they formerly paid to the U.S. Treasury are paid instead to bondholders and to banks.

Rather than go back over the first portion of my written testimony where I discuss my concerns for the economy as a whole, I would like instead to use these few minutes to discuss, first of all, several principles that I think should guide you in considering tax changes, and then to briefly outline two solutions.

The principles, I think, are as follows: First, the problem is not just an LBO problem or a takeover problem. By that, I mean we should be concerned about the loss of corporate financial flexibility and the risks entailed, whether the debt is incurred to finance a management buyout to restructure, or whatever. In short, any legislation cannot focus just on takeover related debt but on debt generally. First because the problem is much broader and, second, because efforts to focus on the basis of a borrower's purpose have historically proved to be unworkable.

The second principle is that the problem is not just a junk bond problem but a junk debt problem. From a taxing policy point of view, there is no reason to distinguish public issue bonds, on the one hand, from bank debt or other privately placed debt on the other.

Third, I believe that the double tax system by which we tax income at the corporate level and again at the shareholder level should be retained with only very minor exceptions. The junk debt dilemma is a function of how we tax business, how we measure corporate income and can be solved well enough within the present two-tier framework.

And the fourth principle, and I think the most important principle, is that we should level the playing field between debt and equity so that the corporate tax structure is neutral as between the two. Quite simply, the amount of corporate income tax should not be affected by a corporation's capital structure, by whether there is more or less debt.

Dividends and interest should be treated alike, and the form of the investment should not matter to the Treasury.

I have two proposals to make, and I regard either one of them as being workable and useful.

First, we could make both dividends and interest payments equally deductible from corporate taxable income. If we did nothing more than that, obviously there would be a loss of corporate tax revenue. The proposal would not be revenue neutral.

To avoid that loss of revenue, the suggestion is that we limit both the interest and dividend deduction to some level, for example, 80 percent of the amount of the payment, or whatever other proportion would be revenue neutral.

This 80–20 proposal is sometimes called the hybrid solution. In addition to being revenue neutral, it would also be essentially neutral as between debt and equity.

The alternative solution, which some others also support, would be to make neither interest nor dividends deductible at all. Relying on some data in a recent study prepared by the staff of the Joint Committee on Taxation, I believe that if we eliminated the interest deduction, we would roughly double the amount of taxable corporate income. The tax rate, therefore, could be cut in half to about 16 to 18 percent, thus making this proposal also neutral as to the amount of revenue collected.

I regard both proposals as attractive, although I have a mild preference for the second one of the two.

In conclusion of those remarks, let me add one hope or prayer. I appreciate the difficulty, the challenge facing the committee, the difficulty of acting before the blood flows. But I think I speak for a growing consensus when I urge that you act. The risks of highly leveraged corporate structures in America, with over $300 billion of junk debt of one kind or another, represents a threat not just to a company here or there, but to the country as a whole.

Our financial system has weathered some heavy blows of late. Bank loans to Third World borrowers and savings and loans. While we are a rich nation, our ability to withstand financial shocks is not unlimited.

Mr. Chairman, I thank you.

[The statement of Mr. Lowenstein follows:]

Statement before
Committee on Ways and Means
U. S. House of Representatives
May 17, 1989

Louis Lowenstein
Simon H. Rifkind Professor of Law
Columbia University

Hearings on Tax Policy Aspects of Mergers & Acquisitions

Mr. Chairman, I welcome the opportunity to be with you today, because I think these hearings can be a vital factor in educating the country that something needs to be done, that we are already leveraging American industry to a dangerous and unsustainable degree. There are specific actions that Congress can take, and I will discuss those. But junk bond financed takeovers and restructurings are a large, complex problem, one from which there is no immediate pain -- and indeed for some of us, rather sweet rewards. It is a problem that does not change visibly day to day. There is no particular group in the private sector that bears the burden or even the responsibility. There is no antijunk lobby, no "Alliance for Capital Prudence." The almost inevitable result is the sort of delay and risk of calamity that befell the savings and loans. My concern is that the same may be true here.

I. The Problem

Capitol Hill sometimes seems far removed from Wall Street, but for a moment I want to transport you still further, to a bank on Main Street USA. You may not recognize the town, but the banker looks a good deal like Jimmy Stewart in "It's A Wonderful Life." As the scene opens, a neighbor of his, Tom Jones, has explained that he wants to buy out his Aunt Dorothy, who owns all the stock of the company that Tom manages. The company has been consistently earning $100,000 a year before taxes. Like everyone who has ever sold a business, Aunt Dot wants $1 million. Tom, who has almost no money of his own, needs a loan, a big loan.

The rest of that little drama could be played out a number of ways, but the conclusion is always the same. "Tom," says the lean, tall banker, "you know I can't lend you that much. The interest charges alone would exceed your earnings, and where would the repayments come from? I like your Aunt Dot, but her price is too high." At that point Mr. Stewart, the banker, swivels in his wooden chair a few times, talks of meeting Tom over the weekend, but both of them know that it's no deal.

Back in the real world, down on Park Avenue or Wall Street, that same deal is an instant winner. Tom buys out Aunt Dot, getting about half the money from a bank and the rest from investors who buy a dazzling variety of securities: pay-in-kind debentures, subordinated discount debentures, reset exchangeable debentures, and so on. On Wall Street, the deal not only closes, but the deal-makers celebrate and go home in stretch limos.

Over the past ten years, we have bought and sold much of American industry -- about $1.2 trillion worth,[1] the equivalent of two-thirds of the average value during that time of all publicly traded stocks. Some businesses have not been sold even once, but others, such as Playtex, have been sold several times over. Some, such as Budget Rent-A-Car, have bought and sold themselves several times over, going private, then public, then private again, all within about two years' time. Why hire one of their cars for a month when you can hire the whole company?

Some of these takeovers made very good sense. I am thinking particularly of those where the managers of divisions or units of large conglomerates bought their freedom, so to speak. Liberal financing made it possible, but the secret ingredient was the ability to wrest a business away from a corporate bureaucracy that was often distant, insensitive and just plain ignorant of some of its operations. Ignorant even of the worth of those operations, those distant owners often sold out on bargain terms.

But with the huge volume of mergers that we are seeing, it would be foolish to expect any single, neat answer to the question whether the process is helping or hurting the efficiency of American industry. Those divisional management buyouts I just described are only a small piece -- less than 5%[2] -- of the picture. As almost anyone in the investment banking business will tell you, along with the good deals -- usually the ones they are doing -- there are lots of bad ones.

There are some empirical data, but the meaning of them is ambiguous. Companies that have gone private are showing higher profits in the short run, but we don't know yet about the long run. Despite the prosperity we are enjoying, net investment in the U.S., as a share of gross national product, has declined by 30% from the 1970s and even more from the 1960s.[3] Spending on oil exploration and development is down, which may represent a sensible saving or it may have increased the risk that we will once again be held hostage by OPEC.

On most of these larger, macro-economic issues, it is simply too soon to tell.

But while we may not have immediate answers on whether takeovers are improving or hurting the long-run efficiency of American industry, we do get valuable insights even now, if we look at the more purely financial aspects. Finance is like the thermometer of business. It doesn't give us a complete diagnosis, but it does tell us a good deal about the general well-being of the patient.

The finance thermometer tells us that the merger-takeover patient is running a fever. The prices being paid for companies are so high that the buyer is frequently losing money from day-one. Just as Tom Jones would have been. The banks and other lenders who make it all possible seem not to be deterred by the red ink. Or more accurately, to avoid facing up to it they have invented new yardsticks of value that say "it isn't so," and new securities that postpone -- but do not avoid -- the day of reckoning.

There is an increasingly familiar shape to the process. It is the shape of a bubble. We have only to think back to the "nifty-fifty" stocks of the 1970s, when respected money managers thought it was prudent to buy Xerox and Polaroid at prices as high as 100 times their annual earnings. Or the conglomerates of the 1960s, when the names were different but the story was essentially the same. And so on back to tulips in the 17th century and whatever it was in Athens that excited men's greed and for a time robbed them of their judgment.

Unlike tulips most bubbles don't matter very much. After all, who cares if the price of houses in the Hamptons gets out of hand? Or if kiwis go through the roof?

The current takeover boom may not rival tulips, but for several reasons it is no mere kiwi, either. I have grouped those reasons under four headings. As you will see, however, it is number three, the junk bond aspect, on which we shall focus most of our attention.

First, the volume of takeovers, leveraged buyouts (LBOs) and other such deals is itself a big deal. In 1975 the total value of all announced mergers was $12 billion. By 1985 it had grown fifteen-fold to $180 billion. It remained at about that level through 1987. Last year that plateau was pierced. Announced mergers of all kinds, friendly, hostile or somewhere in between, reached $268 billion, or about 10% of the average total value of all stocks listed on an exchange or traded in the principal over-the-counter market.

Large as it is, last year's $268 billion actually understates the intensity of this activity. Many companies, rather than wait for a raider, such as Boone Pickens or the Haft family, to knock on the door, borrowed large amounts of money and shrunk their businesses in order to finance the buy-back of a large portion of their outstanding stock. The economic and financial effects were substantially the same as if the company had undergone a leveraged buyout.

Chicago School economists claim that the process is revitalizing

American industry. But the sheer magnitude of it should make us wonder whether that much of American industry could have been so undermanaged, or how it is that takeovers could be the "magic bullet" that would cure so widespread an affliction. Or whether the job of cleaning out the cobwebs and inefficiencies hasn't been done, but other, more speculative forces continue to drive the market.

Second, the buyers of these companies have paid stunning prices. In earlier merger waves a bidder might pay a premium of 20% or so over market for a target company,[4] but in the contested takeovers that we are now seeing, the premiums have consistently averaged 80%. In some of the largest acquisitions, such as RJR Nabisco and Kraft, the premiums were almost 100%.

A premium of 80% has far-flung implications. Your Aunt Dot back home is thrilled that her $10,000 investment in Kraft or whatever is about to turn into $18,000. It's not quite as moving as "Gone With the Wind," which comes along only once in a lifetime, but it does make her sit up and take notice. Take an ordinary company, worth a billion dollars or so, and in no time at all you have $800 million of new, additional wealth.

Wall Street has created a private mint. At first, that $800 million seems to be lying loose on the table, as if it didn't really belong to the Aunt Dots of the world. And while everyone loves Aunt Dot, still they are sorely tempted to scrape off a bit here and a bit there for themselves. The lawyers, bankers and such regularly take about 4-5% of the total for running the mint, or about $10-12 billion last year. That is why Aunt Dot gets only $18,000, and not closer to $19,000. No matter what the size of the deal, those fees stay at about 4-5%. In RJR, when it's all done, I think we will see fees that easily exceed $1.25 billion. Wall Street is about the only place in America that never has to sell its product cheaper by the dozen.

Ivan Boesky and a few of his friends -- there were quite a few -- tried to scrape off just a fraction of one percent. Congress wrote two new insider trading statutes to stop Ivan. Mr. Giuliani, who had labored in relative obscurity until he found Ivan, became a celebrity -- and perhaps the mayor of New York. Some corporate presidents who otherwise would have cried when their companies came under the gun -- and in public still do -- take a piece of the 80% in the form of golden parachutes. One of them, Gerald Tsai of Primerica (né American Can) sold off good packaging businesses in order to buy a brokerage house and the like. Almost immediately, however, he decided not to waste his life running a business when he could bail out in a $50 million, very golden parachute by selling it.

Third, this merger boom still would not have been very different from others but for the fact that the bidders were using almost entirely borrowed money, not their own. Kohlberg, Kravis and Roberts bought RJR Nabisco for about $25 billion. They put in some equity capital of their own, it is true, but it was just about enough to cover the legal and banking fees. In effect, they bought a premier group of businesses almost entirely with other people's money.

This extraordinary reliance on debt is most visible in the leveraged buyouts -- in finance, leverage means borrowed capital -- but it characterizes this entire merger wave. Unlike the 1960s, almost no companies are being bought for stock. Even when, as in the sale of Kraft for $13 billion, the purchaser is a substantial public company, Philip Morris, the currency is cash and most of the cash is borrowed.

The rule of thumb for these buyouts has been that you can borrow nine dollars for each one of your own. After the dust has settled, it often looks more like nineteen to one. But no matter, even at nine to one the arithmetic is very simple and very compelling. If stocks are selling at an average of $12 or so for each $1 of their annual earnings, as they have been recently, and if you pay a premium of 80% over market, you are going to pay about $20 or more for each $1 of earnings you have bought.[5] That means you will get about a five percent return -- $1 a year for each $20 you invested. By issuing bonds instead of stocks to raise the necessary money, by paying interest that is tax deductible instead of dividends that are not, you can eliminate the corporate income taxes that the old company, poor fools, had been incurring. The old Allied Stores, for example, had been paying about

$130 million a year in income taxes, but the new Allied/Campeau is as exempt from income taxes as Columbia University. (That's the only resemblance.) That increases your return to 7 or 8 percent.

By projecting sharply higher earnings -- and no one projects lower ones -- you can increase your expected return to 10 or 11 percent. But at that point the string has run out. Except for an occasional miracle, the supply of which is limited, you have a breakeven situation at best. Since all that borrowed money will cost 12 percent and more, the earnings are unlikely to exceed the interest charges. In the jargon of finance, the coverage of fixed charges (roughly the ratio of income to interest charges) will average no better than about 1:1. A judicious amount of leverage is normal, but the margin of safety that bondholders traditionally expected, the coverage of fixed charges four or six times over, has disappeared.

In many of the largest transactions, the coverage has been even less than 1:1. The new Allied Stores started life with earnings of $290 million to cover interest charges of $460 million. The new Duracell, $125 million of operating income to cover $203 million of interest. The new Federated Department Stores -- that's Bloomingdale's and so on -- $400 million of earnings and $600 million of interest.

At some point in each merger boom two things happen. The first is that a number of economists insist that everything is fine, that the market is working its inevitable magic, even if it's not visible, and that we should relax and enjoy the ride. The second is the invention of funny money. As prices escalate, there isn't enough "serious" money -- cash of your own or investment grade securities -- to keep the game going.

The funny money syndrome is inescapable. In the 1960s it was common stock in one form or another. Conglomerate corporations, such as Gulf & Western, were the darlings of Wall Street, and their stocks were selling at very inflated prices. Using their high priced stocks as currency, Gulf & Western, ITT and other conglomerates could pay $800 for an ordinary cat by selling, in effect, a $900 dog. In the 1920s, Samuel Insull and others used pyramided holding companies to accomplish the same thing.

For today's empire builders, people like Campeau, William Farley, Frank Lorenzo, and Kohlberg Kravis, Wall Street has created an updated version of funny money, called the junk loan. Junk can be a bond issued publicly, or a loan from a bank, or more usually a combination of both. About $200 billion of low-rated, junk bonds are now outstanding. But banks have also lent aggressively to the same borrowers,[6] bringing the aggregate LBO-type debt to well over $300 billion. Those are very large numbers. Several money-center banks are said to have invested over 100% of their stockholders' equity in LBO loans.[7]

A new LBO company cannot seriously promise to pay $1.50 of interest for each dollar of income without resorting to smoke and mirrors, or what I call "superjunk." These are the zero-coupon, discount, or pay-in-kind debentures that have proliferated in recent deals. The nomenclature is confusing, but the underlying concept is simple enough. In the case of zero-coupon bonds and other superjunk, it is obvious that the issuer -- be it Federated Department Stores, Fort Howard, or RJR Nabisco -- has assumed so much more debt than it can service, it needs an immediate moratorium on part of the interest payments. Federated, for example, has issued debentures on which it pretends to pay 17-3/4% a year. It makes all the usual entries on its books. But until 1994 the coupons on the debentures all say "zero." Federated keeps the cash.

Zero-coupon bonds are symptomatic of how far we have strained the usual bounds of prudence. Swiss bankers, I am told, make it a rule never to lend to those who have to borrow still again to repay their debts. Zero-coupons neatly dodge the problem. You simply cannot default on a zero obligation.

Zero-coupons first appeared as a form of U.S. Treasury bond and served several modestly useful purposes. It's true that we had gotten along for 200 years without them; but as Treasury bonds they were acceptable, because there was no question about the government's ability to repay. Under the pressure to bid ever higher prices for takeover targets, however, investment bankers adapted the zero-coupon to loans that stood at the bottom of the credit heap, instead of the top.

At this point the obvious question is, who buys this junk? The answer, surprisingly enough, is not your Aunt Dot. At least not directly. Ninety percent of all junk bonds are bought by institutional investors, primarily mutual funds and insurance companies.

Aunt Dot would never buy a Federated Department Stores' zero-coupon bond. Never, never. It's a bond that for five years pays no interest and, because it is so junior a security, earns none. Worse yet, the federal government will tax you as if you had received the money. In short, it would mean buying a bond that pays no interest, in substance earns none, but is taxed as if it did both. At the end of five years you would have paid out an extra forty cents or so in taxes for each dollar originally invested, with not a nickel in return.

Aunt Dot may not work on Wall Street, but she knows the difference between paying and receiving.

Over $50 billion of junk bonds have been bought in managed accounts and by mutual funds, for example, whose managers seem to lack the simple wisdom of Aunt Dot. What sells these so-called high-yield mutual funds is their advertised yield. And as in other periods of excess, such as the 1920s and 1960s, accountants are letting operators hide behind yesterday's rules -- adequate for the period for which they were written -- to conceal today's tricks.

The accounting problem grows out of the fact that until recently an investor in a bond fund could assume that the bonds in the portfolio represented securities that were senior to some significant shareholder net worth. In the last few years, however, companies have systematically come to market with bonds even though they do not earn their interest charges with a reasonable margin of safety -- that is, where the equity exists in name only.[8] Let me explain. For a moment, assume you own all of Federated Department Stores, with no debt at all. You would be earning almost $400 million a year before taxes. While that's not bad --they give you a private elevator at Bloomie's -- it is all you earn. But because Federated has promised to pay interest at the rate of $600 million a year, the accountants are allowing mutual funds and other institutional investors, to tell the world that they are earning from Federated 50% more than Federated itself is earning. By the magic of financial alchemy, a dollar there is turned into a dollar and a half here.

I recently looked at thirty companies in the bond portfolios of two high yield mutual funds. The numbers were grim. Of the thirty companies, a majority -- 17 in all -- had failed to earn the interest payments on which one or the other of these mutual funds were relying. In some cases, such as Texas Air, Southland, Western Union, and Burlington Holdings, earnings fell short of interest expense by 30% or more. For the group as a whole, the coverage of fixed charges was just about 1:1. All this at a time of peak prosperity.

The ultimate irony is that Aunt Dot might have earned nearly the same (or better) real, economic returns by purchasing good bonds. She would have paid less in taxes, and she would have slept better. Bonds of Capital Cities/ABC, for example, were selling recently at prices that yield 10-1/4%. And every dollar of Capital Cities net interest expense is covered by eight dollars or more of income.

While I have talked about particular companies, I see them as something more. I see them as symptomatic of a boom period when memories are short and when it is considered normal, even prudent, to strive for maximum immediate results even while leaving no room for a rainy day. The blessing of the last seven years of prosperity has been that the gamble has largely worked. The curse of it has been that people have begun to believe that we need not provide for the lean years.

I wish these concerns were limited to some specific sector, such as mutual funds. But banks have lent heavily into these same LBOs. And apart from mutual funds, there are over $100 billion of junk bonds in the hands of insurance companies, pension funds, and other institutions. Assuming their junk is no better than what we have seen here, they also are far too willing to boast about high yields today and let the risks wait until tomorrow.

Many economists and finance people, in and out of the academy, do not share these concerns about excessive corporate debt. The disagreement is far-ranging, and I will address only a few aspects. First, there is the view that interest charges should be compared not to earnings, but rather to earnings plus depreciation, what is usually called cash flow. In other words, corporations are better off than I have suggested, because they have more real income, cash income, available to meet those interest charges than I have indicated. A second argument, an extension of the first, is that even if corporate managers are starved for money, it is a good thing, not bad. In this view, managers are profligate and self-indulgent. By imposing on them high interest costs, they will be forced to cut back on corporate staffs, jet aircraft and other overhead expenses in ways they were never forced to do before.

The notion that all is well if cash flows cover the interest charges, that we can add back to earnings the depreciation charge, is a fantasy -- a dangerous fantasy. A depreciation charge is simply a way of amortizing or writing off the cost of a company's plant and equipment, thereby recognizing that plants and equipment wear out or become obsolete. Accounting principles aside, the problem is simply that you cannot spend the same dollar twice. You can use a dollar of depreciation either for reinvestment or to pay interest charges, not both. For the years 1977-86, the capital expenditures of American industry -- expenditures to replace worn out or obsolete equipment and also to expand -- were not less than, they were about twice as large as, the depreciation charges. (They equaled 89% of total cash income -- depreciation plus earnings -- leaving only 11% for dividends and all other purposes.[9]) And even that was not enough. Our reinvestment in the 1980s has been woefully inadequate, a far smaller share of national income than in any decade since World War II.[10] Productivity has been hurt.[11] We have lost ground in the competition for global markets.

The argument that those reinvestment dollars can now be diverted to the payment of interest charges is nonsense. That it surfaces so widely is symptomatic of a "jam-today" attitude that afflicts this entire debate.

The second argument, that a heavy debt load disciplines corporate managers, begins from an acceptable starting point but reaches an absurd conclusion. It turns the parable of the ant and grasshopper upside down. Professors Bernanke and Campbell at Princeton call it the "backs-to-the-wall" theory. Everyone needs to be watched, of course, and corporate managers are no different. More than one CEO has tried to enlarge his corporate empire at shareholder expense. The question is the remedy. The question is whether the imposition of a huge burden of debt on the back of American industry will cut just fat, or whether we are now down to bone and muscle. The question is whether the global competition will be won by companies that are rich, that have money to invest, or by those that are poor.

The debt load is already too heavy, not just for a company here or there but for industry taken at large. Some of the data are reassuring, but many of them raise storm signals. Let me give you a small sample:

* Our corporations have been borrowing in good times in ways historically reserved for bad times. The percentage of cash flows of industrial corporations dedicated to interest payments was less than 8% in the mid-1960s. In the recessions of 1974 and 1982 it rose to 22%, at most.[12] Now in the seventh year of a long and substantial business expansion, when corporate profits are at historically unsustainable levels -- a median return on equity of over 16% last year for the Fortune 500 -- by some estimates interest payments account for 26% of internal cash flow.[13]

* Standard & Poor's reports that the median industrial bond rated by it has dropped from an A-rated, investment grade bond in 1981 to a BB-rated, junk bond in 1988.

* Much of this new corporate debt shows up in industries, such as oil and gas, mining, department stores and paper, that are cyclical or capital intensive or both.[14] But even for manufacturing and mining as a whole, the degree of leverage approximates that of the public utilities in 1929,[15] and it was the utilities -- which should have suffered the least -- that soon suffered some of the most dramatic failures.

A little over a year ago, after the stock market crash, I wrote an op-ed piece saying that junk bond financed takeovers were probably at an end. More recently, Secretary of the Treasury Brady said much the same thing. I am delighted to have such estimable company, but, alas, the bubble still has not burst. In the immortal words of Yogi Berra, "it ain't over 'til it's over."

I recognize, of course, that all through the 1980s, the default rate on junk bonds has been acceptably modest. Economists have produced studies showing how few losses there have been. They are right, in the sense that Chicken Little to the contrary, the sky has not fallen. On reflection, however, these studies are about as interesting as a test of umbrellas when the sun is shining. Over 95 percent of all junk bonds have been issued since 1982 and so have yet to be tested by a business downturn.[16] All we know is that even during a period of peak prosperity, the earnings of many companies do not equal their interest charges. The question is, what will happen when the business cycle turns?

Experience tells us that we will in time have a business downturn. After that op-ed piece, I sold my crystal ball, so I have no idea when. But it will happen. When it does, experience also suggests that it will be more severe because of our grasshopper-like tendencies. Relying on data through 1986, Bernanke and Campbell did a now celebrated study of 1400 public companies and concluded that, in a recession similar to that of 1982, 10% of all firms would fail.[17] The figure would be higher today.

Almost every day someone is saying that we shouldn't worry about debt, because we are simply moving closer to the higher levels of debt that have long prevailed in Germany and Japan. Unfortunately the German and Japanese experience has little relevance for us. The pattern of investing is vastly different in those two countries than here. In both cases, there is what might be called "relationship investing," meaning that the loan is only a part of a larger investment -- part of a continuing web of relationships. That web takes the form of debt, but also stocks, representation on boards of directors and a high degree of control.

In Germany and Japan, the ownership of both the debt and the equity is much more concentrated than in the U.S. Deutsche Bank may lend money to Daimler Benz, but it also has voting control of that company and only recently used that control to effect a change in management. In short, Germany has a merchant banking structure in which the three major banks have a profound influence and power over German industry that is not to be found in the United States. Not surprisingly, the German stock market is primitive.

The commitment and continuity that characterize German banking are missing here. The LBO debt that worries some of us is floated off, either in a public offering or through the banking system. But even if through the banking system, the relationship between lender and borrower is quickly attenuated. Bankers Trust, which is a major lender in the LBO market, has kept less than 5% of the LBO debt that it originated.[18]

The Japanese situation is even less like ours. There is an intricate pattern of cross-ownership of stocks and much of the lending is within the family of any given keiretsu, or group of companies. But apart from interlocking boards and cross-ownership, the Japanese culture is so different from ours that a bare comparison of debt-equity ratios is not meaningful.

I said earlier on that many of the LBOs and other takeovers were well conceived and executed. I am equally confident that many were not, and that many bidders will someday be forced to write off at faded prices their "tulips" of the 1980s. But there were $268 billion of merger announcements last year, and it would be foolish to overgeneralize in either direction.

Except to say this: if the process is sound, if it is the magic bullet that is cutting fat and not too much muscle, why put such splendid gains at so much risk? Why is living on the thin edge an essential part of the process?

Before turning to solutions, I should like to go back briefly to Main Street, where I began. It would be nice to report that Main Street can expect to survive this experience unscathed. No such luck. The local banker, Jimmy Stewart, turned down the loan to Tom Jones, but then he bought participations in Wall Street deals that were no better.

As for Aunt Dot, who sold her Kraft stock at a splendid profit, she has been the pride of laissez-faire economists. They take delight in explaining that her gains are representative of gains in the economy as a whole. But what if those economists have been looking at half-time scores, when it is the 60-minute result that counts? If so, Aunt Dot may not be richer for having sold stock at a premium. If Aunt Dot is simply a proxy for all of us, then what she has done is to sell the stock of a quite good company, Kraft, pay a quite hefty tax, and then (through a mutual fund) invest much of the balance in quite weak, junk bond companies elsewhere. If my analysis today is anywhere near the mark, in the end she will not have gained by that exchange. And neither will we.

II. The Need for a Tax Solution. . .Now

There is nothing inherently wrong with low-quality or junk bonds in moderate amounts and if the marketing is not deceptive. As junk bond takeovers and restructurings have proliferated, however, the quality of the deals and of the junk itself has deteriorated. A major engine driving the process has been the corporate tax provision that favors debt over equity, that makes interest deductible and dividends not. Look at company after company, Kroger, USG and others. Simply by substituting debt for equity, by eliminating the corporate income tax, they jump in value 40-50%. Dollars that corporations formerly paid to Uncle Sam are paid instead to bondholders and banks.

LBO funds have pooled $30 billion or more of equity and mezzanine money and are ready to borrow nine dollars for each one of their own. Short of a calamity, it will be very difficult to stop the process. Unless we level out the playing field between debt and equity, unless we revise the tax code, we will continue to turn the balance sheets of American industry into junk.

I appreciate the enormous difficulty of the challenge facing the committee, the difficulty of acting before the blood flows. But I think I speak for a growing consensus, when I urge that you act. Our financial system has weathered some heavy blows of late, notably bank loans to Third World borrowers and to fools and knaves at savings and loans. We are a rich nation, but our ability to withstand financial shocks is not unlimited.

The committee is, of course, hearing contrary advice. There are some who are saying that if you even consider action now, you will bring another Black Monday down on our heads. The SEC, for one, which ought to know better, seems to have suggested as much. What caused the collapse of stock prices in October 1987, however, was primarily the bubble that was growing out of hand all through late 1986 and through the summer of 1987. It was one of the best publicized bubbles in history. Yes, it is quite possible that this committee was holding one of the pins that burst that bubble. But so what? If there hadn't been a pin at that time, presumably the bubble would have continued to grow -- and then what? We should put the blame where it belongs, on the bubble not the pin.

III. Suggested Tax Changes

First, in thinking about how to chill excessive debt, let me suggest several guidelines:

(a) the problem is not just an LBO problem, or a takeover problem. By that I mean that we should be concerned about the loss of corporate financial flexibility, and the risk that we will end up socializing the losses -- just as we are doing in the banking system -- whether the debt is incurred to finance an LBO, to "restructure," or whatever. In short, the legislation should not focus just on takeover-related debt, but on debt generally, not just because the problem is broader but because earlier efforts to legislate on the basis of a borrower's purpose seem unworkable. Money is marvelously fungible, and tracing the proceeds of a loan is a mare's nest. It didn't work for Section 279, nor for the greenmail tax. I doubt that it would work here.

(b) the problem is not just a junk bond problem, but a junk debt problem. From a tax and policy point of view, there is no reason to distinguish public issue bonds from bank debt or other privately placed debt.

(c) the double-tax system, by which we tax income at the corporate level and again at the shareholder level, should be retained, with only minor exceptions. The junk debt dilemma is a function of how we tax business, how we measure corporate income, and can be solved well enough within the present two-tier framework.

(d) most importantly, we should level the playing field between debt and equity, so that the corporate tax structure is neutral as between the two. Quite simply, the amount of corporate income tax should not be affected by a corporation's capital structure, by whether there is more (or less) debt. Dividends and interest should be treated alike. The form of the investment would still matter to lenders and shareholders, but not to the Treasury.

There are two basic choices that meet this goal of tax neutrality. First, we could make both dividends and interest payments equally deductible from corporate income. There would, of course, be a loss of corporate tax revenue, if that were the only change. To avoid a loss of revenue, Congress could either increase the tax rate -- which I don't suggest -- or it could limit both the interest and dividend deduction, for example, to 80 percent of the amount of the payment (or whatever other proportion would be revenue neutral). This 80-20 proposal is sometimes called the "hybrid solution." In addition to being revenue neutral, it would also be essentially neutral as between debt and equity. But not perfectly so. Interest is deductible as it accrues, regardless of when it is in fact paid out, whereas the earnings that accrue on common stock would be deductible only when paid. There would be pressure, therefore, for payouts, which may be a good thing or bad, but the arrangement is not wholly neutral.

The second choice is to make neither interest nor dividends deductible at all. Relying on data in the recent study prepared by the staff of the Joint Committee on Taxation (Table IV-F), I believe that eliminating the interest deduction would roughly double the amount of taxable corporate income. The tax rate, therefore, could be cut in half, to about 16-18 percent, thus making this proposal also neutral as to the amount revenue collected. This second proposal, however, may well be more attractive as a conceptual matter. The corporate business would be taxed, but the tax would not be affected by purely financial decisions. The tax would be the same regardless of the choice between debt and equity and regardless of the payout ratio on the common stock.

I regard both proposals as attractive, with a mild preference for the second one. The income tax should be measured by operating income. We should not be able to use debt/equity choices to jiggle the result. In addition, the "no-deduction" proposal also solves the problem that at present some U.S. source income escapes taxation here altogether, i.e., in those cases where the debt is held by foreign investors. On the other hand, I recognize that the loss of any tax incentive to pay out income would be regarded by some as a disadvantage.

In either case, it would be necessary to phase in the changes over a period of several years. The second choice, in particular, would otherwise prejudice companies that are capital intensive, such as finance companies and public utilities. Those problems are not insuperable, but they do need to be dealt with. (For utilities, the phase-in period might be stretched out. For finance companies, it might be enough to tax interest income on a "net" basis, i.e., tax it only to the extent that it exceeds interest income.) Similarly, we might elect to exempt small companies entirely from the double tax, much as if they had all elected to be taxed as partnerships, as many of them now do.

Second, the capital gains tax needs fixing. The tax could be dropped to 15%, for example, for securities held for five years or more and raised to 50% for those held for less than one year, or whatever similar version is revenue neutral. The short-term tax should apply to otherwise tax-exempt institutions. The merger market is not the only one that is being driven by short-termism, but it is an important aspect of the problem.

In conclusion, let me urge you not to fall into the trap of so many other committees that have addressed these issues: lots of hearings, lots of bills, lots of inertia.

* * *

1. Source: W. T. Grimm & Co.

2. W. T. Grimm & Co., Mergerstat Review 1987, p.70.

3. Statement by Alan Greenspan before the National Economic Commission, November 16, 1988, reprinted in Fed. Res. Bull. Mar. 1989, page 139.

4. Source: W. T. Grimm & Co.

5. W. T. Grimm, Mergerstat Review 1987, p. 104.

6. Bartlett, Bankers Defend Buyout Loans but Investors Fret, New York Times, Oct. 28, 1988, p. D1, col. 3.

7. Source: Baupost Group, Inc. (citing Paine Webber).

8. As Seth Klarman, general partner of The Baupost Group, Cambridge, Mass., has pointed out, in many of today's LBOs there appears to be some shareholders' equity, but it is an illusion. There are neither earnings nor assets to support the "equity," which exists only on the liability side of the balance sheet. As he explained, issuing an additional $4 billion of cram-down securities to the RJR stockholders does not improve the safety of the more senior lenders. Grant's Interest Rate Observer, April 28, 1989, pp. 9-11.

9. Cottle, Murray & Block, Graham & Dodd's Security Analysis, 5th ed., at 261-2.

10. Greenspan, supra; Altman, Awaiting Investment, Wall St. J., Mar. 10, 1989, page A16, col.4. Lowest share of national income in any sustained period since WW II, per Friedman, page 5, Testimony before House Comm. on Budget, Jan. 25, 1989.

11. Altman, ibid.

12. Henry Kaufman, The Decapitalization of American Corporations, Speech before the National Press Club, Jan. 10, 1989, at 5; The Economist, Oct. 15, 1988, at 79-80. See also Testimony of Benjamin Friedman, House Committee on Ways and Means, January 31, 1989, at 8-9.

13. Kaufman, supra, at 5.

14. Id. at 79-80.

15. F. M. Scherer, Public Policy Issues of High-Yield Debt, paper delivered at Salomon Brothers Conference Center, N.Y.U., Dec. 9, 1988, at 6-7.

16. Perry & Taggart, supra.

17. Bernanke & Campbell, Is There a Corporate Debt Crisis? 1 Brookings Papers on Economic Activity (1988) 83.

18. Guenther, Bankers Trust Has $2.7 Billion in Loans for Buy-Outs, Totaling 11% of Portfolio, Wall St. J., Dec. 8, 1988, p. A6, col. 3.

Chairman **Rostenkowski**. Thank you very much, professor.

Mr. Dorgan will inquire.

Mr. **Dorgan**. Thank you, Mr. Chairman.

Let me say obviously I find your testimony more comforting, but this is not a one-dimensional issue. All of us understand that, and although I represent a point of view, I feel very strongly about it. I understand there are people who feel strongly on all sides of this.

And I would like to especially ask Mr. Lowenstein about something in his prepared statement, and then also ask Mr. Sterling a question.

In your prepared statement, on page 13, you said this,

> I recently looked at 30 companies in the bond portfolios of two high yield mutual funds. The numbers were grim. Of the 30 companies, a majority—17 in all—had failed to earn the interest payments on which one or the other of these mutual funds were relying, In some cases, such as Texas Air, Southland, Western Union, and Burlington Holdings, earnings fell short of interest expense by 30 percent or more. For the group as a whole, the coverage of fixed charges was just about one to one. All this at a time of peak prosperity.

Were some of those holdings zeros or PIK's I assume in which interest was earned but not paid? And therefore they are not in default but, in fact, did not earn enough to cover interest payments?

Mr. **Lowenstein**. In some of those companies, they were indeed zeroes and PIK's. In the case of one of the mutual funds, over 15 percent, I don't know how much over because I only looked at 40 percent of the portfolio, but over 15 percent of the interest that they were boasting about and talking to their shareholders, they were not receiving in cash. There were zeroes, PIK's and other what I call super junk.

Mr. **Dorgan**. Have you come across any instances of default on zero coupon bonds in terms of interest payments?

Mr. **Lowenstein**. Well, a zero coupon bond is a fantastic invention. You cannot fail to pay a zero coupon. There is no way of defaulting on it no matter how hard you try.

Mr. **Dorgan**. At least in the early years?

Mr. **Lowenstein**. Most of them run for 5 years so that the day of reckoning for many of these is 1992 to 1994.

If you look at RJR, for example, which is our largest and most visible transaction to date, this was a company that was, of course, extremely profitable, and would have paid $700 million or so this year in income taxes. But as a result of the restructuring there is a deficit of $700 million, and that is largely represented by funny money zero coupons, PIK's, and all of the other paraphernalia.

Mr. **Dorgan**. In some of your writing, Mr. Lowenstein, you have represented some earlier studies, and I know that the studies don't bring us up to date, some earlier studies that belied the contention that is, as you put it, the princess kissing the toad, turning him into a prince. That is a search for undermanaged, underperforming companies and turning them into better performers.

You reference some analysis that suggested that the targets in particularly hostile takeover areas, in fact were targets that were performing slightly above average prior to acquisition and below average after acquisition.

Could you amplify on that a bit?

Mr. **Lowenstein**. There was a study that Professor Herman at the Wharton School and I did, and we looked at every significant hostile takeover bid, from 1975 to 1983 that met our specifications. And particularly as time went on, as we got into the transactions that began in the 1980's, the targets were very good companies. They were performing as well as or better than their counterparts either in American industry or within their particular industry segment.

Mr. **Dorgan**. But Mr. Pickens suggested that somehow these were a bunch of ne'er-do-wells who just didn't know how to manage their assets.

Does the studies you have done demonstrate that's not the case? Is Mr. Pickens wrong?

Mr. **Lowenstein**. Mr. Pickens works from a lot of great old metaphors about hunting dogs and stuff. But when you look at it, I don't think the claims hold up. We referred also earlier today to studies by Professor Kaplan or Mr. Kaplan, University of Chicago, suggesting that LBO's do better coming out than their old companies.

Let me suggest there is a very good report and an analysis of both that study and of the self-serving study by Kohlberg, Kravis prepared by Long & Ravensccraft from Brookings, that analyzes those studies apart and, I think, leaves you with the conclusion that it's just too soon to tell.

Mr. **Dorgan**. Mr. Sterling, let me say, rather than ask you a question, observed that in your testimony you provided us with some very useful analyses of some distinctions that might be made between equity and debt instruments. And I know that a number of us on the committee have found them very useful already, and that's the kind of work I think we need in order to determine what we might do, if anything.

No one here is predisposed to running off and doing something quickly or without consideration. And there is not even any judgment that something is going to be done. The purpose of these hearings is to determine whether something should be done and, if so, what should be done. And all of us fully understand the need to be careful and considered in our judgments.

But I think the contribution you have made is very important, and I just want to say I appreciate it.

Mr. **Sterling**. Thank you, sir.

Chairman **Rostenkowski**. Mr. Pease.

Mr. **Pease**. Thank you, Mr. Chairman, and thanks to both of our witnesses for their excellent testimony.

I would like to second the comments of my colleague, Mr. Dorgan. I think the suggestions that were made have been very helpful to us.

As it has been pointed out, they are contradictory to what Mr. Pickens told us a moment ago. Mr. Pickens basically says that there is nothing at all wrong with LBO's, that they serve a useful purpose. They would not occur if managements were not managing their companies poorly, and therefore you ought to let the laws of economics rule what happens. You suggest otherwise.

Is either one of you prepared to make a categorical statement that you think LBO's, in general, are unhealthful to the economy and ought to be curbed by this committee?

Mr. **Sterling**. That may depend on how you define LBO's.

I tend to think that the acquisition process is something that should not, basically, be interfered with except to the extent that it is subsidized by the tax law. If it is subsidized by the tax law, as I think it is at the moment, yes, I would do something about it so that it precedes free of tax subsidy and strictly on its own unsubsidized tax merits.

Mr. **Pease**. Mr. Lowenstein.

Mr. **Lowenstein**. I have two concerns about the LBO process, Mr. Pease. I agree with Mr. Sterling—that in substantial part it is tax driven.

But I have a second concern about it, and that is the lurking breach of fiduciary duty. I agree with Mr. Dorgan's comments earlier, and I specifically disagree with Mr. Pickens' comments earlier. I think that companies, well-managed companies, frequently sell at substantial discounts from their real values. I am reminded of one that is based here in Washington. The Washington Post Co. for years sold at very large discounts from its immediate breakup value. No one ever thought that the Washington Post Co. was not a well-managed business.

Therefore, I am concerned about corporate managers who, seeing that the company's stock is selling below its intrinsic value, decide that there is an opportunity there for them, personally, to capture those values. If the values are there and the stock is cheap, then there are ways of restoring the balance. Let them do a share repurchase program that benefits all of the shareholders and does not put them on the other side of the table from the people for whom they are supposed to be working.

Mr. **Pease**. All right, thank you. I think it is well for us to be reminded of the tax subsidy aspects of these LBO's. That certainly is a matter entirely within our jurisdiction.

Questions were asked of Mr. Pickens, again, about the short-term versus the long-term orientation of companies and the fact that the availability of junk bonds and the activity of takeover artists just drives American companies even more in the direction of short-term profitability than would otherwise be the case.

Mr. Pickens says that is not so. A good company manages for the short term, the medium term, and the long term. I do not find myself much reassured by that.

What is your feeling about, specifically, the impact of LBO's, or the potential for LBO's, on the long-term profitability, and therefore competitiveness of American companies, say, in relation to what we see in Japan?

Mr. **Sterling**. Congressman, my view on that is that if there is a particularly highly leveraged acquisition, there may be a great need for early cash-flow to help service that highly leveraged debt. And if there is a great need for early cash-flow to service debt, that is obviously going to have an impact on how management manages a company. They need cash to service the debt they have just taken on to buy the company. And that, by definition, will mean that cash is not available for other purposes that they might spend it on if they were not so highly leveraged.

So my view is that the highly leveraged acquisition does have a strong tendency to cause corporations not to spend their money on the things that we would like them to be spending it on, like reinvestment in the future.

Mr. **Lowenstein**. I am in substantial agreement. Let me just amplify those comments slightly.

You can only spend a dollar once, not twice. And if you look at the financial statements of company after company going into these LBO's—Duracell, Federated Department Store—company after company—the list is almost endless—Burlington Holding, Western Union, and the like—you will see that the money is committed to paying the interest charges. Even then there is not enough.

You cannot spend it twice. You either spend it on reinvestment or you pay the banker, and the banker has the first claim.

If you look at capital investment in the United States, the rate of investment in the United States as a percentage of gross national product, is 30 percent in the 1980's below what it was in the 1970's, still less than it was in the 1960's. It is the lowest of any decade since World War II.

I think there was earlier testimony here by Professor Friedman from Harvard who said substantially the same effect. Numbers like that just keep rolling off almost every week.

We are not reinvesting enough in America.

Mr. **Pease**. Thank you very much. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Are there any further questions?

[No response.]

Chairman **Rostenkowski**. Thank you very much, gentlemen. Thank you for joining us this morning. You have both been helpful.

Mr. Baker, Mr. Hackett, Mr. Huard.

[Pause.]

Chairman **Rostenkowski**. The Chair would like to announce that it is his intention to work through lunch.

You gentlemen know the format. If you have a statement that is longer than the time that has been allocated, we would like you to summarize it. However, your entire testimony will be placed in the record. When you are called upon I would like you to identify yourself for the record.

Mr. Baker, you may begin.

STATEMENT OF JAMES K. BAKER, VICE CHAIRMAN, U.S. CHAMBER OF COMMERCE, AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ARVIN INDUSTRIES, INC., COLUMBUS, IN

Mr. **Baker**. Thank you, Mr. Chairman. My name is James K. Baker. I am vice chairman of the U.S. Chamber of Commerce, and am here today representing the views of the chamber.

The chamber commends this committee for its efforts to examine deliberately and carefully the issues raised by the recent increase in LBO activity. Any policy changes in this area will have far-reaching and often unintended effects on the U.S. economy. The ultimate goal of any legislation should be to promote long-term economic growth and competitiveness of U.S. industry.

We all recognize the value of equity. A firm that uses more equity financing is more likely to successfully overcome adverse financial circumstances. Yet our present tax system is quite biased against equity financing.

First, dividends are double and sometimes triple-taxed under present law; and second, capital gains are taxed at too high a rate at both the corporate and shareholder level.

These provisions tend to raise the cost of capital, reduce long-term economic growth, and impede the ability of U.S. businesses to compete in the international marketplace.

The United States is the only major industrialized country that fully taxes both corporate income and corporate dividends paid to shareholders as the appendix to my written statement shows.

Intercorporate dividends are often triple taxed. Almost since the advent of the income tax, our tax system has provided a dividends received deduction, or a DRD, to alleviate this triple taxation. Presently, 30 percent of intercorporate dividends are triple taxed.

The DRD plays a particularly important role in the preferred stock market. A very high percentage of this important type of equity financing is held by other corporations. DRD reduction or repeal would raise the tax cost of preferred stock to prohibitive levels, and would force corporations to use even more debt financing.

We strongly urge the committee to retain the DRD.

To reduce the tax bias against equity investments and to reduce the cost of capital to American firms, Congress should implement a program of dividend relief. This could be accomplished in several ways. A shareholder level credit compensating shareholders for the corporate level tax on distributed earnings could be provided. This is the integration system adopted by many European countries. The primary disadvantage of this approach is its administrative complexity.

Under committee option C1, shareholders would be required to gross-up their income by the amount of the credit. A credit method provides a more exact means of eliminating the corporate level tax on distributed earnings than a dividends received deduction or exclusion because the credit would be worth precisely the same amount to all taxpayers no matter what their tax bracket.

A credit method, dividends received deduction or exclusion would, for a given degree of dividend relief, cost the Treasury substantially less revenue than a dividends paid deduction because of the inability of tax-exempt entities to take advantage of a credit deduction or exclusion.

Interest is a business expense and should be deductible as such. The chamber is opposed to limiting the deductibility of interest. A tax system that purports to measure and tax net income or profit should allow expenses incurred to offset general revenue. To do otherwise would constitute a stark departure from the traditional principles of the U.S. tax system, which has allowed business interest to be deductible from its inception.

We do not want our tax system to become a gross income tax system, a system that is widely denounced by economists of all political persuasions because of the distortions they cause.

Finally, limiting the deductibility of interest expense incurred by U.S. corporations will simply raise their cost of capital compared to their foreign competitors, and will reduce production, will reduce job creation, and will reduce productivity growth.

The committee press release contains nine proposed limitations on the deductibility of interest expense. Option B1 rests on the premise that all hostile takeovers are undesirable and should be subject to punitive taxation. Under option B2, the interest limitations would be triggered if the new management intended to reduce substantially employment in the target firm.

The chamber, consistent with its belief that interest expense is an ordinary and necessary business expense and that the tax system should tax net income, would oppose both of these options.

Options B3 and B6 would limit the interest deduction only to loans with a sufficiently low interest rate or with sufficient seniority or collateral. The chamber opposes imposing a Federal ceiling on deductible interest or requiring collateralization or seniority before interest on an instrument would be deductible. Small- and medium-sized businesses would suffer the most from such a provision.

Options B4 and B5 would disallow an arbitrary percentage of corporate interest expense. Business interest expense should remain fully deductible.

Options B7 and B8 would establish normative debt to equity ratios, and options such as these could radically raise the cost of capital for precisely those firms that have the most difficulty gaining access to needed capital.

Section 385 of the Internal Revenue Code presently exists to police abusive debt-equity ratios, and the courts have enforced this provision.

Investment banking income should be taxed at the same rate as other business income.

Option E1 would establish a series of complex interest allocation, foreign currency gain and loss rules for the purpose of limiting the interest expense of the U.S. corporation owned by foreign persons. This is an unworkable proposal.

Option E2 is unsound. It would have no impact on the relative ability of United States and foreign firms to acquire U.S. firms, and would deny U.S. companies access to Eurodollar credit markets.

In conclusion, the chamber supports dividends relief and a reduction in the capital gains tax rate to reduce the tax bias against equity financing, and opposes efforts to limit the deductibility of business interest expense.

In addition, the dividends received deduction should not be reduced, and counterproductive and unadministerable foreign tax provisions should not be enacted.

Thank you.

[The statement of James K. Baker follows:]

STATEMENT
on
THE TAX POLICY ASPECTS OF MERGERS, ACQUISITIONS AND LEVERAGED BUYOUTS
before the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U. S. CHAMBER OF COMMERCE
by
James K. Baker
May 17, 1989

My name is James K. Baker. I am Vice Chairman of the U. S. Chamber of Commerce and Chairman and Chief Executive Officer of Arvin Industries, Incorporated. I am here today representing the views of the Chamber. Because of its broad membership base, the Chamber offers a unique perspective on the problems that we are addressing here today.

The policy issues raised by recent increases in merger and acquisition activity, leveraged buyouts (LBOs) and corporate debt levels are complex. Many aspects of the present situation are troubling, and the Chamber commends this committee for its efforts to examine deliberately and carefully the many legislative proposals. As part of the process, the public has been invited to comment on a host of possible changes in the tax treatment of mergers, acquisitions and leveraged buyouts. My remarks will be limited to addressing the proposals set forth in the press release announcing this hearing. The Chamber addressed additional policy issues in earlier testimony before this committee.

Any policy changes in this area will have profound, far-reaching and often unintended effects on the U.S. economy. Often, simply proposing a policy change will have a dramatic impact on the marketplace. Thus, prudence should be the watchword as Congress proceeds to examine its options in this area. Throughout the entire process, the ultimate goal of any legislation should be to promote long-term economic growth, competitiveness and prosperity.

The Tax Bias Against Equity Finance

Businesses are contractually obligated to make interest payments on debt while dividends paid to equity holders are discretionary and can be deferred if a company is experiencing financial difficulties. All other things being equal, a firm that relies more heavily on equity finance is more likely to overcome adverse financial circumstances.

Yet our present tax system is quite biased against equity finance. There are two primary reasons for this bias. First, dividends are double- and sometimes triple-taxed under present law. Second, capital gains are taxed at too high a rate at both the corporate and shareholder level. These factors tend to raise the cost of capital, reduce long-term economic growth and impede the ability of U.S. businesses to compete in the international marketplace.

The U.S. is one of the few industrialized countries that fully taxes both corporate income and corporate dividends paid to shareholders (see Appendix). U.S. corporations are taxed at a rate of 34 percent. Shareholders are taxed again on corporate earnings when they are distributed at rates as high as 33 percent. Thus, the effective federal tax rate on distributed earnings is often as high as 56 percent. When state taxes are considered, the effective rate on distributed earnings often exceeds two-thirds.

Intercorporate dividends are often triple-taxed. The payor corporation is taxed on its profits; the recipient corporation is taxed on its dividend income; and the recipient corporation's shareholders are taxed on their dividends as well. Almost since the advent of the income tax, our tax system has provided a dividends received deduction (DRD) to alleviate this triple taxation. Presently, the DRD stands at 70 percent for most intercorporate dividends. Thus, 30 percent of intercorporate dividends are triple-taxed.

Last year's House tax bill contained a provision that would have reduced the DRD to 50 percent. This was widely viewed as a prelude to outright repeal of the DRD. This proposal would exacerbate the tax system's bias against equity finance. The DRD plays a particularly important role in the preferred stock market. A very high percentage of this important means of equity finance is held by other corporations. A reduction or repeal of the DRD would have a devastating impact on the ability of firms to use preferred stock as a method of corporate finance. DRD reduction or repeal would raise the tax cost of preferred stock to prohibitive levels and would force corporations to use debt finance. We would strongly urge the committee to retain the DRD.

Dividend Relief Is Appropriate

To reduce the tax bias against equity investments and to reduce the cost of capital to American firms, Congress should implement a program of dividend relief. This could be accomplished in several ways, including a dividends paid deduction, a dividends received deduction or exclusion, a reduced corporate rate on distributed earnings or a system of shareholder credits for corporate taxes paid. The committee press release addresses three options.

A shareholder-level credit compensating shareholders in whole or in part for the corporate level tax on distributed earnings could be provided. This is the integration system adopted by many of our European trading partners. The primary disadvantage of this approach is its administrative complexity. Firms would be required to calculate the amount of the credit and issue information reports informing shareholders of the amount. Under committee option C1, shareholders would be required to "gross up" their income by the amount of the credit.

A credit method provides a more exact means of eliminating the corporate-level tax on distributed earnings than a dividends received deduction or exclusion, because the credit would be worth precisely the same amount to all taxpayers no matter what their tax bracket. A credit, in other words, is likely to be of relatively greater value to taxpayers with modest incomes such as retirees living off of their investments. But given the relative similarity of the corporate rate and the top individual rate under present law, this seems to be a relatively small advantage. As with a general dividends received deduction or exclusion (committee option C2), the credit method of integration is qualitatively different than a dividends paid deduction (committee option C3), because the first-order tax benefit accrues to dividend recipients rather than the corporation, and because corporate income distributed to tax-exempt entities, such as pension funds, nonprofits or foreigners, would be taxed at the corporate level. A credit method, dividends received deduction or exclusion would, for a given degree of dividend relief, cost the Treasury substantially less revenue than a dividends paid deduction because of the inability of tax-exempt entities to take advantage of a credit, deduction or exclusion.

The Tax Treatment of Interest Expense

Interest is a business expense and should be deductible as such. The Chamber is opposed to limiting the deductibility of interest. A central reason that interest should remain deductible is fairness. A tax system that purports to measure and tax net income or profit should allow expenses incurred to offset gross revenue. To do otherwise would constitute a stark departure from the traditional principles of the U.S. tax system, which has allowed business interest to be deductible from its inception. Moreover, to disallow interest expense would introduce a host of destructive capital market distortions. To the extent that interest expense were not deductible, our tax system would become a gross income tax system similar in many respects to the "cascading" gross sales tax that prevailed in Europe for many years and the gross income taxes that still exist in many developing countries. Gross income taxes are widely denounced by economists of all political persuasions because of the distortions they cause. Under such a regime, two companies that have equal income will often have radically different tax liabilities. Finally, limiting the deductibility of interest expense incurred by U.S. corporations will simply raise their cost of capital in both absolute terms and compared to their foreign competitors, who will remain able to deduct their financing costs. These higher capital costs will reduce production, job creation and productivity growth.

The committee press release contains nine proposed limitations on the deductibility of interest expense. Options B1 and B2 would deny the deductibility of interest on debt incurred to finance a hostile takeover or a merger deemed by the Federal Trade Commission not to be in the public interest, respectively. Option B1 rests on the premise that all hostile takeovers are undesirable and should be subject to punitive taxation. Under option B2, the interest limitations would be triggered if the new management intended to reduce substantially employment in the target firm in a county, city or other jurisdiction. This form of tax-oriented plant closing proposal would reduce substantially the ability of management to improve the efficiency of its firm and would constitute an important step toward a European-style system with a high degree of inflexibility and stagnation. The Chamber, consistent with its belief that interest expense is an ordinary and necessary business expense and that the tax system should tax net income, would oppose both of these options.

Options B3 and B6 would limit the interest deduction only to loans with a sufficiently low interest rate (for example, three percent over the applicable federal rate) or loans with sufficient seniority or collateral. The Chamber opposes imposing a federal ceiling on interest rates or requiring a certain degree of collateralization or seniority before interest on an instrument would be deductible. Arms-length market transactions between lenders and borrowers should not be second-guessed by the Internal Revenue Service (IRS). Moreover, it is virtually assured that to the extent that the interest rate, collateralization and subordination limitations were set at levels where meaningful numbers of transactions were affected, small- and medium-size businesses would suffer the most. In many cases, such a provision would effectively deny them access to capital markets.

Options B4 and B5 would simply disallow all or an arbitrary percentage of corporate interest expense. The Chamber opposes reducing the interest expense deduction by any arbitrary percentage or repealing it. Business interest expense should remain fully deductible for purposes of computing taxable income.

Option B7 and B8 would establish normative debt to equity ratios. Thus, under option B7, if the debt to equity ratio exceeded 80 percent, then interest deductibility would be cut in half. While this may foster and environment in which debt financed LBO's would be less desirable, this is an area rife with danger and complexity. For example, small businesses are usually quite highly leveraged because they have very limited access to equity markets. An option such as this could radically raise the cost of capital to precisely those firms that have the most difficulty gaining access to needed capital.

Section 385 of the Internal Revenue Code presently exists to police abusive debt-equity ratios. The courts have enforced this provision. But it is an area rife with danger and complexity. The Treasury has twice issued and subsequently withdrawn regulations governing debt-equity ratios because the regulations led to unfair and economically counterproductive results in practice.

Investment Banking Fees

Investment banking and other professional income should be taxed at the same rate as other business income.

Foreign Tax Aspects

Option E1 would establish a series of complex interest allocation, subsidiary consolidation and foreign currency gain and loss rules for the purpose of limiting the interest expense of, or imputing income to, a U.S. corporation owned by foreign persons if the interest incurred by the foreign person would not have been deductible had it been a U.S. person under various interest limitations schemes. The complexity and unadministrability of the present foreign tax rules are well-known both to the IRS and the private sector. This option would further exacerbate this disturbing trend. Moreover, such a rule would require the U.S. government to conduct worldwide audits of foreign multinationals' non-U.S. operations with an eye toward disallowing interest expense or imputing income to the U.S. subsidiary on the basis of loans incurred by other subsidiaries of the foreign parent. This unworkable proposal should be dropped.

Option E2 would impose a 30 percent withholding tax on interest earned by foreign persons on portfolio debt in the U.S. This proposal is unsound and, in addition, would have no impact on the relative ability of U.S. and foreign firms to acquire U.S. firms.

This proposal would deny U.S. companies and the U.S. government access to Eurodollar credit markets. The dictates of the marketplace are such that the borrowers would be required to increase their interest payments to compensate for the new tax. U.S. corporations would then find that accessing the Eurodollar credit markets was uneconomical until U.S. interest rates rose. They would be forced to borrow instead in the U.S. This higher demand for domestic credit would tend to increase U.S. interest rates. Higher U.S. interest rates would have an adverse economic impact on all businesses and individuals who borrow.

Securities Law, Financial Regulation and Corporate Governance

The Chamber is systematically reviewing many proposed changes in securities law, financial institution regulation and corporate governance law designed to protect bondholders, stockholders and employees. Many of these proposals may have merit. But all raise a host of complex questions. The relevant Chamber committees are reviewing the proposals and many will be addressed by the Chamber Board at its June 14th meeting.

The Chamber has, however, consistently endorsed the position that corporate governance and shareholder relations should be left to the states without federal preemption, and that the role of the federal government under the Williams Act should be strengthened to provide for complete, accurate and prompt disclosure.

Conclusion

Congress should proceed carefully as it addresses the complex issues being raised at this hearing. Any policy proposal should be judged by its likely impact on the cost of capital, competitiveness and economic growth. The policy initiatives that are most appropriate are the provision of substantial dividend relief and the reinstatement of the capital gains differential. Interest expense should remain deductible as a business expense, and adverse changes in the taxation of foreign income should be avoided.

Thank you.

APPENDIX

INTERNATIONAL COMPARISONS OF TREATMENT OF EQUITY
G-7 COUNTRIES

Country	Double Taxation of Dividends	Capital Gains Tax Rates For Individuals
Canada	Partial relief from double taxation.	Only a portion of capital gains is included in income. 17.51% maximum rate
France	Full relief from double taxation through the combination of a partial shareholder credit and a partial deduction to the corporation for dividends paid.	No capital gains tax, unless the taxpayer has held more than 25% of the shares of a non-listed company at any time during the 5 years prior to sale, or total sales of listed shares for the year are more than FF 288,400 (in 1988). The rate for these exceptions is 16 percent.
Germany	Full relief from double taxation. Shareholders receive credit for the corporate tax paid.	No capital gains tax if shares are held at least 6 months. If shares are held less than 6 months, capital gains will be taxed at normal rates. A shareholder who owns more than 25% of a company and sells all or part thereof will be taxed at preferred rates.
Italy	Full relief from double taxation. Shareholders receive credit for the corporate tax paid.	Capital gains are taxed (at regular income rates) only if the shareholder holds the shares less than 5 years and shares transferred exceed 5% of capital or 2% in the case of shares quoted at a stock exchange.
Japan	Partial relief from double taxation.	Shareholder has a choice of a 20% national and a 6% local tax on net gain at the time of filing, or 1% of sales proceeds withheld at source (this option is available only on shares listed for at least 1 year).
U.K.	Partial relief from double taxation.	40% with indexation.
U.S.	No relief from the double taxation of dividends.	Taxed at regular income rate, generally 28% or 33%.

Source: Arthur Young and Company.

Mr. RUSSO [presiding]. Thank you very much, Mr. Baker.
Mr. Huard.

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you. I am Paul Huard, vice president of NAM's taxation and fiscal policy department. I am pleased to be here today to present the views of our members.

Earlier this year NAM formed the task force of tax experts from its member companies to examine, among other things, some of the more novel options described in the committee's hearing notice of April 12, 1989, such as penalty taxes on certain corporate acquisitions and/or fees in transactions related thereto.

This examination is still in process, and will not be completed for several more months. Nevertheless, on the basis of existing tax policies of the association, we are able to offer definitive views on the following areas of the committee's inquiry.

First, NAM is opposed to limitations on the deductibility of interest. This opposition is based on our belief that the Federal corporate income tax is intended to and should be a tax on that income, not a tax on gross receipts.

Accordingly, we believe tax deductions for business expenses should be permitted in full without being circumscribed by percentage limitations, dollar caps or other restrictions. This important principle has already been eroded in a number of unfortunate instances, for example, in the area of business meals and entertainment.

We feel strongly that it is important to hold the line on any further erosion, otherwise there is a significant risk that the incessant demand for more revenue will lead to widespread and indiscriminate use of arbitrary and artificial limitations on deductions crucial to the accurate determination of net income.

Moreover, denial of interest deductibility as a device to inhibit certain corporate financing transactions is subject to the following serious objection: it would not affect foreign acquirors, thus giving them an unfair advantage over U.S. firms.

While a number of creative solutions to this difficulty have been advanced, we believe the committee should be suspicious of the validity and enforceability, under both the U.S. Constitution and international tax law, of any attempt to make what are, in effect, domestic tax law-based sanctions on borrowing apply extraterritorially to a foreign acquiror who borrows funds outside the United States.

It is fairly certain that recent increases in corporate debt levels reflect the fact that under present U.S. tax law, equity is treated much more harshly than debt. Dividend payments to shareholders are at least doubly taxed—more than doubly in the case of some intercorporate dividends—whereas interest payments to a corporation's bondholders and other creditors are not.

Nonetheless, a time-honored adage applies here: "Two wrongs don't make a right." Under present law, interest is treated properly and dividends improperly. The answer is most assuredly not to level the playing field by treating both improperly.

As my remarks indicate, NAM believes a high-priority goal of Federal tax policy should be proper integration of the corporate and personal income tax systems, so as to eliminate the multiply taxation of corporate earnings paid out as dividends.

Under no circumstances, however, should this be financed by offsetting reductions in the corporate tax deduction for interest paid. The present imbalance should be corrected by improving the treatment of equity, not by worsening the treatment of debt.

The takeover/LBO phenomenon may be a manifestation of the lack of long-term investment outlook. To the extent that it is, this in turn probably reflects the fact that Federal income tax laws no longer provide adequate treatment for long-term capital gains. Such gains are now taxed at ordinary income rates, with the result that many sellers of long-held capital assets are taxed even though, as a result of inflation, they have enjoyed no real economic gain, and may, indeed, have suffered a substantial real economic loss.

NAM believes a preferential rate structure for long-term capital gains would, among other things, help foster a more long-term investment outlook. Looking at the situation from a competitive standpoint, many of our trading partners do not tax capital gains at all.

We, therefore, suggest that the committee consider the merits of some sort of sliding scale of preferential capital gains tax rates, declining eventually to zero. At the very least, the cost basis of capital assets should be fully indexed for inflation, so that only real gains are taxed under the Federal income tax system.

The last area I would like to address is the withholding on foreign-held portfolio debt. The Deficit Reduction Act of 1984 repealed the 30-percent withholding tax on interest earned by foreign persons on portfolio debt in the United States. This was a correct and desirable tax policy decision that significantly improved the access of U.S. borrowers to reasonably priced international credit sources. This decision should not be reversed.

NAM opposes reinstatement of this withholding tax at any rate. As a general proposition, we also oppose solutions directed at foreign persons which involve overriding provisions of our existing tax treaties.

This concludes my remark on those particular options in the committee's April 12 notice as to which we have a clearly applicable position. I would be glad to answer any questions the members may have.

[The statement of Paul R. Huard follows:]

TESTIMONY ON THE TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

BY

PAUL R. HUARD
VICE PRESIDENT, TAXATION AND FISCAL POLICY
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

MAY 17, 1989

I am Paul R. Huard, Vice President of the Taxation and Fiscal Policy Department of the National Association of Manufacturers. I am pleased to be here today to present the views of our members on a number of the legislative options being considered by the Committee in connection with its ongoing hearings on the tax policy aspects of mergers, acquisitions and leveraged buyouts [LBOs]. The Committee is to be commended for undertaking this important inquiry. Recognizing the sensitivity of financial markets to some of the options being examined, we also applaud the cautious and deliberate fashion in which the Committee has proceeded to date.

NAM believes that Congress is right to be concerned about the growing number and size of both takeovers and LBOs. These related phenomena raise a number of important questions which demand careful study. One of these clearly is whether our financial markets now disproportionately value short-term over long-term performance. Another is whether increased levels of corporate debt are giving rise to unreasonable risks of major defaults in the event of a sharp rise in interest rates, a recession or other economic developments that might jeopardize corporations' ability to service their debt. We are also concerned that short-term perspectives and overreliance on debt may be adversely affecting our international competitiveness.

Earlier this year, NAM formed a task force of tax experts from its member companies to examine, among other things, some of the more novel options described in the Committee's hearing notice of April 12, 1989, such as penalty taxes on certain corporate acquisitions and/or transactions related thereto. This examination is still in process and will not be completed for several more months. Nevertheless, on the basis of existing tax policies of the Association, we are able to offer definite views on the following areas of the Committee's inquiry:

Restrictions on Interest Deductibility. NAM is opposed to limitations on the deductibility of interest. This opposition is based on our belief that the federal corporate income tax is intended to--and should--be a tax on net income, not a tax on gross receipts. Accordingly, we believe tax deductions for business expenses should be permitted in full, without being circumscribed by percentage limitations, dollar caps, or other restrictions. This important principle has already been eroded in a number of unfortunate instances, for example in the area of business meals and entertainment. We feel strongly that it is important to hold the line on any further erosion. Otherwise, there is a significant risk that the incessant demand for more revenue will lead to widespread and indiscriminate use of arbitrary and artificial limitations on deductions crucial to the accurate determination of income.

Moreover, denial of interest deductibility as a device to inhibit certain corporate financing transactions is subject to the following serious objection: it would not affect foreign acquirors, thus giving them an unfair advantage over U.S. firms. While a number of creative solutions to this difficulty have been suggested, we believe the Committee should be suspicious of the validity--under both the U.S. Constitution and international law--of any attempt to make what are in effect tax-based sanctions on borrowing apply extraterritorially to a foreign acquiror who borrows funds outside the United States.

It is fairly certain that recent increases in corporate debt levels reflect the fact that, under present U.S. tax law, equity is treated much more harshly than debt. Dividend payments to shareholders are at least doubly taxed--more than doubly in the case of some intercorporate dividends--whereas interest payments to a corporation's bondholders and other creditors are not. Nonetheless, a time-honored adage applies here: "Two wrongs don't make a right." Under present law, interest is treated properly and dividends improperly. The answer is most assuredly not to "level the playing field" by treating both improperly.

Balanced Treatment of Debt and Equity. As my prior remarks indicate, NAM believes a high priority goal of federal tax policy should be proper integration of the corporate and personal income tax systems, so as to eliminate the multiple taxation of corporate earnings paid out as dividends. Under no circumstances, however, should this be financed by offsetting reductions in the corporate tax deduction for interest paid. The present imbalance should be corrected by improving the treatment of equity, not by worsening the treatment of debt.

Improved Treatment of Long-Term Capital Gains. As I noted earlier, the takeover/LBO phenomemon may be a manifestation of the lack of long-term outlook. To the extent it is, this in turn probably reflects the fact that federal income tax laws no longer provide adequate treatment of long-term capital gains. Such gains are now taxed at ordinary income rates, with the result that many sellers of long-held capital assets are taxed even though, as a result of inflation, they have enjoyed no real economic gain and may instead have suffered a substantial real economic loss.

NAM believes a preferential rate structure for long-term capital gains would, among other things, help foster a more long-term investment outlook. And, looking at the situation from a competitive standpoint, a number of our trading partners do not tax capital gains at all. We therefore suggest that the Committee consider the merits of some sort of sliding scale of preferential capital gains tax rates, declining eventually to zero. At the very least, the cost bases of capital assets should be fully indexed for inflation, so that only real gains are taxed.

Withholding on Foreign-Held Portfolio Debt. The Deficit Reduction Act of 1984 repealed the 30% withholding tax on interest earned by foreign persons on portfolio debt in the United States. This was a correct and desirable tax policy decision that significantly improved the access of U.S. borrowers to reasonably-priced international credit. This decision should not be reversed. NAM opposes reinstatement of this withholding tax at any rate. In general, we also oppose "solutions" directed at foreign persons which involve overriding provisions of our existing tax treaties.

This concludes my remarks on those particular legislative options in the Committee's April 12, 1989 hearing notice as to which NAM has a clearly applicable tax policy position. I would be glad to turn now to any specific questions any member of the Committee may have.

Mr. Russo. Thank you very much, Mr. Huard.
Mr. Hackett.

STATEMENT OF LEE P. HACKETT, SENIOR VICE PRESIDENT, AMERICAN APPRAISAL ASSOCIATES, MILWAUKEE, WI

Mr. Hackett. Thank you, Mr. Russo. My name is Lee Hackett. I am senior vice president of American Appraisal Associates. I am in charge of managing the National Practice Office. I have been with the firm for over 26 years as a valuation consultant and as an owner and senior manager.

Frankly, Mr. Russo, I appreciate your indulgence, given the weightiness of the matters brought forth by my fellow panelists and prior panelists, to allow me to indulge in section D matters relating to the possibility of an excise tax on service fees for advisers and providers of fairness opinions and solvency letters.

By way of background, our firm is the largest independent international valuation firm, 93 years in existence headquartered in Milwaukee, WI, with 34 offices in the United States, operations in Canada, Europe, Mexico, and the Far East, 1,000 employees on a worldwide basis.

We measure the size of our firm and our largeness in terms of valuation, in terms of number of personnel, and value of assets appraised annually. Our studies encompass all kinds of industrial and commercial uses both in the public and private sector, including steel, oil and gas, automotive, consumer products, communications, municipalities, and institutions.

The nature of these studies include tax and financial reporting for mergers and acquisitions, financing, estate planning, purchase and sale, fixed asset accounting, and cost segregation. Most pertinent, certainly, to today's discussion, we are in the business of rendering fairness opinions and solvency opinions in a wide range of transactions, both for leveraged buyouts and other forms of mergers and acquisitions.

I think it is important to note that for all of our services, including fairness and solvency, we have established practice standards for consistency in the application of our studies. It is also important to note that there is an adherence to these standards assured by our internal audit team which looks at 8 to 10 percent of the jobs done per year.

We spend $4.5 million and 4,000 hours checking the validity and compliance to our own standards. This also includes training for compliance and mastery testing of all of our personnel. Failure to comply impacts compensation, promotion, and possibly results in dismissal.

Of importance today are the discussions of fairness opinions and solvency letters. As you all know, a fairness opinion is advice rendered to the board of directors upon which they can then advise shareholders as to the financial terms of a deal and the fairness thereof. It applies to both public and private companies, but most attention is being paid these days to the public side.

In determining fairness in financial terms, one must consider all of the variables that influence the transaction price, such as trade names, market position, distribution network, customer relations, and synergies in the transaction. This is in addition to doing all of the various levels of value that may be appropriate to the consideration, a going concern value, a breakup value, a transaction value.

Certainly the recent court cases would support the need for the adequacy and the reliability of data upon which directors and shareholders can rely. Then there is raised, certainly, the question of independence of the provider of the opinion as a party to the transaction and/or the fee being contingent on the outcome of the deal.

Solvency letters are distinguished from fairness letters, but are reliance vehicles in most LBO transactions. Reliance primarily for lenders that their interests are not being subordinated, but also reliance for directors of selling firms as to their fiduciary responsibility to protect the interests of the selling shareholder.

In essence, solvency opinions support the fact that the transaction does not render the surviving corporation insolvent. It is measured by assets exceeding liabilities, the ability to repay debts in the normal course of business, and the adequacy of capital to maintain business operations.

Therefore, the provider of that opinion must address the subject of present fair saleable value, in a real and not hypothetical market, as well as all pro forma and contingent liabilities surrounding surviving corporations. In addition, there are requirements for sensitivity testing which address the general economic conditions which adjust the interest rates, the volume, and price growth assumptions.

There are actions, we believe, which can assure the objectivity and independence of these opinions. Issuers can be required to be independent parties to the transaction, definitive standards can be set for one, the factors to be considered, two, methods to be applied, three, the level of detail necessary for reliance and four, that the fee basis for opinions be based only on the service rendered.

It is our opinion that section D, suggesting some type of excise tax on fees of advisers, could be counterproductive and not necessarily address the perceived abuses. The increased cost of the service, for instance, could produce undesired results such as the use of lesser skilled employees, cost-cutting measures in providing lower quality of service, or a passthrough of the cost without assuring an improvement in the validity to the users of the end product.

Therefore, it is our recommendation that the Congress consider using the existing Securities and Exchange Commission regulatory framework, not the alternative of taxation. The Securities Act of 1934, rule 13e-3 provides a framework which can assure the fairness and validity of adviser services.

We recommend an extension of the rule to include protection of shareholders in third party transactions even though existing management may not be directly involved.

We also recommend the rule require opinion providers to be otherwise independent of the transaction that the fees not to be tied to the outcome of the deal, and that there be full disclosure of the investigation in terms of factors considered, methods used, and the reason and logic for weighting used in reaching these conclusions.

We believe the substance of these recommendations are currently under consideration by the SEC, and believe that this framework will assure proper treatment of all parties to and around a business transaction.

Thank you.

[The statement of Lee P. Hackett follows:]

TESTIMONY OF
LEE P. HACKETT

Senior Vice President
American Appraisal Associates

before the
Committee on Ways and Means
May 17, 1989

Mr. Chairman, members of the Committee on Ways and Means, thank you for inviting me to testify before you. My name is Lee P. Hackett, and I am Senior Vice President of American Appraisal Associates, responsible for managing the firm's National Practice Office.

BACKGROUND

American Appraisal Associates is the oldest and largest valuation firm in the world. Formed in 1896, we are an international consulting firm specializing in valuing businesses. Each year, we prepare valuation studies for more than $100 billion in tangible and intangible assets and capital stock. We are headquartered in Milwaukee, Wisconsin, have 33 offices in this country and subsidiaries and affiliates around the world.

Our studies and consultation services address the valuation issues involved in acquisitions and divestitures; leveraged and management buyouts; financing; business reorganizations; investment and industrial real estate; closely held businesses and capital stock; and other corporate planning and strategy needs. We've been involved in more mergers and acquisitions than any other firm in our field including three of the five largest such transactions in 1988. Our services include fairness and solvency opinions prior to the sale, as well as valuations for tax and accounting purposes when the transaction is completed.

American Appraisal employs 780 people in its domestic operations of which 300 are on our professional services staff. In addition, American Appraisal employs 200 people in its international operation. In the history of our firm, we have served over 85 percent of the corporations on Fortune's list of 500.

To insure consistent practices and procedures for each of our offices, American Appraisal has created an extensive quality assurance program of standards, training and audits. It is an investment of $4.5 million and 4,000 hours each year. In-house valuation standards and strict requirements for the professional development of our appraisers are applied on a company-wide basis to assure the quality of our work. We publish an appraisal practice and procedure manual which consists of a series of volumes on such targeted subjects as general valuation data, property valuation, functional service procedures, administrative procedures, and special technical manuals. Upon joining American Appraisal, each professional appraiser receives a set of these manuals and, during his or her employment, compliance is monitored by the firm. Each year we conduct an internal audit of between 8 to 10 percent of our work on a random basis to verify adherence to standards. Promotions and compensation are tied to our quality assurance program.

We also are committed to education and training at American Appraisal. We publish a Professional Development Manual which sets forth job descriptions, requirements for each professional staff classification, and guidelines for training, professional recognition and advancement. In order to advance to a more sophisticated appraisal level, employees must complete specified in-house training courses. American Appraisal spends approximately $1.8 million annually on training and education. These are not lost opportunity costs, but out-of-pocket costs which we believe are necessary to train our appraisers. Each year we hold over 70 in-house seminars and meetings on subjects such as technical and valuation theory and practices.

SCOPE OF TESTIMONY

Mr. Chairman, today we would like to focus upon the set of options relating to investment banking fees described in section D of the announcement of hearings on mergers and acquisitions issued by the Committee on April 12, 1989. In particular, we will discuss the relationship of those options to fairness opinions and solvency letters, each of which has become an increasingly important element in mergers and acquisitions.

Fairness Opinions

Fairness opinions are prepared in connection with many mergers and acquisitions. The purpose of a fairness opinion is to determine whether the financial terms of a corporate control transaction are fair to the equity owners or other stakeholders in the company. During the Committee's consideration of mergers and acquisitions, most of the attention has been on transactions involving publicly held companies. It is important to note, however, that the market price for the shares in a public company is not necessarily the most accurate measure of corporate value. Potential acquirors often pay a premium for control, and the fairness opinion takes into consideration all the variables that give rise to that premium.

The fairness opinion is important to all parties to a corporate control transaction. It can give support to the decision of the directors of a target company, or it can persuade shareholders to tender their shares or approve the terms of a merger. Thus, the fairness opinion is particularly important in the types of corporate control transactions that have been examined by the Committee, such as a hostile takeover where the directors decide to reject the offer of the prospective acquiror, or in a management-led leveraged buyout (MBO) where the management has a heightened personal interest in the success of the offer.

In recent years, a series of court cases have focused upon the adequacy of fairness opinions and the duty of care owed by directors because of concern that directors may not be fully informed or that they may interpret the information available to them to serve their own purposes. See, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

Directors and managers have a fiduciary responsibility to inform themselves fully about a transaction and to disclose that information to the shareholders. This should include seeking an independent fairness opinion. Such an opinion can lessen the risk that managers will engage in self-serving practices designed to protect their own jobs, build empires through aggressive acquisitions or be unwilling to accept changes in control which might be in the best interest of the present shareholders.

While most managers and their advisors do not purposefully seek to mislead shareholders, the way that many fairness opinions are currently done does create a perception of a conflict of interest.

For example, a fairness opinion drafted by the investment banking firm that structured the transaction under consideration is subject to question. The bank may be in a position to earn significant additional fees if the prepared fairness opinion simply encourage completion of the transaction.

In other instances, the first investment banker will hire a second for the fairness opinion where fees may also be contingent upon the outcome of the transaction. Shareholders who rely on the validity of the opinion or want know the details of how the opinion was determined may have to use the court system to obtain that information because disclosure is not required in other than a management led buyout.

Solvency Letter

The solvency letter (also known as a solvency/capital adequacy letter or opinion) generally is issued in connection with a corporate control transaction. The purpose of the solvency letter is to provide a basis for reliance to the creditors (principally, the lender) that their interests are not being subordinated to the interests of the shareholders. In order to provide such assurances, the solvency letter must include a determination that the entity (i) has not been made insolvent as a result of taking on new debt, (ii) has the ability to service its debt and any additional obligations triggered by the transaction, and (iii) has a reasonable capital base to operate as an ongoing business.

In the event that the corporation declares bankruptcy because it is unable to meet its obligations and/or continue its business operations, the trustee in bankruptcy may bring an action for a fraudulent conveyance. The parties most in need of legal protection in this situation are the unsecured creditors in leveraged corporate control transactions. Under the law of fraudulent conveyances, if the assurances provided in the solvency letter prove to be unfounded, the result could be -- in an LBO or MBO context -- that the seller has to give back all or a part of the purchase price, that the lender's liens are voided, or that the obligations of the target to the seller or lender are held to be unenforceable or subordinated to the claims of the target's other creditors.

In order to determine that the corporation has sufficient assets to demonstrate that the new debt will not render it insolvent, the issuers of the solvency letter must determine whether the present fair saleable value of the acquired company's assets is greater than the amount of all of its liabilities, both pro forma and contingent. Present fair saleable value is the value which can be obtained if the assets are liquidated with reasonable promptness in an arm's length transaction in an existing and not theoretical market.

OBJECTIVITY AND INDEPENDENCE OF THE PROVIDERS OF THE OPINION AND THE LETTER

The key to assuring the objectivity and independence of the fairness opinion and the solvency letter is establishing a requirement that the issuers of each be otherwise independent of the parties to the transaction. American Appraisal also believes that standards should be established which specify the materials to be reviewed by the issuer, the various methods of valuation that are acceptable and the level of detail necessary for reliance by the parties to the transaction.

To the extent that the issuer of the opinion or letter wishes to vary from these standards and methods, the burden should be on it and the party for whom the opinion or letter is being provided to substantiate and justify the variation.

In addition to requiring the independence of the issuer, fees that are based upon the outcome of the transaction or the dollars involved should be prohibited. The combination of independent conduct and a fee for service will lessen the possibility that a fairness opinion is issued to benefit one party to the transaction.

DISCLOSURE

Substantially more disclosure should be required of issuers of fairness opinions and solvency letters. American Appraisal fully subscribes to the holding of Howing v. Nationwide Corporation, 826 F.2d 1470 (6th Cir. 1987), in which the Court concluded that fairness opinions must disclose how the opinions were reached and how much weight was given to specific considerations in arriving at the conclusions. The current requirements imposed upon the participants in a management led buyout should be extended to include all third party transactions.

IMPOSITION OF AN EXCISE TAX ON THE PROVIDERS OF THE OPINION AND THE LETTER

With these general principles in mind, I would like to comment on the specific proposals before the Committee. Section D of the Committee's announcement suggests that a series of excise taxes could be imposed on the fees or other compensation earned by individuals or entities providing various services in connection with a merger or acquisition. We assume that the primary purpose of the proposal is to encourage a course of conduct that at least some members of the Committee believe to be in the best interest of the public.

American Appraisal does not believe that meeting the objective requires the imposition of excise taxes. As we discussed earlier, it is very important to adopt policies that encourage independent evaluations in connection with both fairness opinions and solvency letters. The operation of economic forces in the market will normally assure independence from the issuer of solvency letters. The lender has the power to demand as a condition of its loan that an acceptable solvency letter be issued. As a result, solvency letters have not been open to significant question.

However, economic market forces may not be sufficient to induce independent fairness opinions in all cases. Unfortunately, imposition of an excise tax on compensation earned by a service provider to a corporate control transaction, on two-tiered rate structures, or on the compensation earned by an adviser or appraiser who plays a second role with respect to the offer on behalf of the company to which advisor or appraisal services are rendered, may be counterproductive.

The excise tax on compensation described in subsection 1 of section D will simply increase the cost of valuation services to interested parties and may cause them to retain less skilled practitioners to the detriment of the interested parties. At a minimum, excise taxes for compensation earned by appraisers may encourage the adoption of cost-cutting measures by the issuers of fairness opinions and solvency letters to the detriment of shareholders, management and creditors alike.

Nor does the imposition of an excise tax upon two-tiered rate structures or upon appraisers and advisors who perform other tasks on behalf of the company to which the advice or appraisal service is provided make them less likely to occur. In some cases, the excise tax may be treated as a cost of obtaining a desired result -- in effect, a license. We believe the interests of shareholders, managers and creditors would be better served by prohibiting such arrangements. In our view, a prohibition enforced by the Securities and Exchange Commission can guarantee the level of protection that the Committee seeks to require.

USING THE REGULATORY FRAMEWORK
THE PREFERRED COURSE

As the Committee knows, under Rule 13e-3 of the Securities Exchange Act of 1934, certain disclosures are required when existing management is a participant in a proposed buyout. These disclosures, which must be provided shareholders at least twenty days in advance of the contemplated transaction, include:

(1) stating whether alternatives were considered by the Board of Directors, and if so, the reason for their rejection;

(2) whether there were firm offers from unaffiliated persons during the preceding 18 months, or longer if a prior offer was for a higher amount;

(3) whether the proposal was approved by a majority of the outside directors;

(4) stating the material factors considered in concluding the offer was fair and the specific weight given to each factor in reaching that conclusion; and

(5) whether a report or other analysis of the transaction has been prepared and, if so, whether there were limitations placed on the preparer of the report and what

those limitations were. If the report has been prepared by an outside party the Rule requires disclosure of the party, its qualifications, terms of engagement, and any potential conflicts it may have.

As the Commission acknowledges there is no effort under the Rule to mandate fairness but simply to provide the information upon which the shareholder can reach his or her own conclusion as to fairness. The rules may be enforced through private action and thus afford a shareholder a remedy if he or she believes the disclosure to have been misleading or incomplete.

We believe these rules provide a good framework for assuring fairness but that they do not go far enough. As a first item, we believe that they should be extended to cover third party transactions, nominally not involving management, recognizing that some of the same conflicts of role will exist even if management is not a formal part of the bidding party. It is not at all unusual for a third party bidder to wish to retain existing management and that there be an understanding of what will follow a successful transaction.

As a second matter we believe that additional steps need to be taken to assure the objectivity of the professional opinion relied upon to determine the fairness of the transaction. There are well known examples of prices declared to be fair that are immediately topped by further bids at much higher levels. While we recognize that a fair price under state law is not necessarily the highest price available at a given time, we think that the likelihood of the shareholder receiving full value is increased if the opinion on the fairness of the transaction comes from a professionally recognized assessor of value who is otherwise independent of the transaction being contemplated.

Third, we believe that full disclosure of the basis for the opinion, the process used to arrive at it and the details of the relationship between the provider and other parties to the transaction should be insisted upon at every stage of the transaction and as a part of the fairness letter itself.

And, fourth, the professional provider should be retained to do just that -- provide a professional opinion. For that reason we believe the fee to be paid that provider should in no way be tied to the outcome of the transaction. In addition, the rules should make clear that no limits can be imposed upon the provider of the opinion with respect to the procedures employed to arrive at the opinion or with respect to its access to information necessary to form its conclusion. The fact that no such limitations have been imposed and that the opinion is independent of any other aspect of the transaction should be required to be a part of the opinion and of the disclosures filed with the SEC.

Many of these issues are under consideration at the Securities and Exchange Commission. In a letter to House Energy and Commerce Committee Chairman John Dingell dated May 1, 1989, SEC Chairman David Ruder stated that the staff inquiry would be completed by mid-June. We believe that the objectives set out in Section D of the Committee's announcement of these hearings are the correct ones and that the regulatory framework presently existing at the SEC offers the best means for achieving those objectives.

Mr. Russo. Thank you very much, Mr. Hackett.

Mr. Baker, in your testimony, you advocate granting relief for equity payments made by corporations, but oppose any changes to corporate interest deductibility.

For someone who serves on the Budget Committee that understands the budgeting problems we face, where would you find funds to pay for the equity relief?

Mr. Baker. Well, I think it is unrealistic to eliminate the double taxation on dividends in 1 year. I think it has to be a phaseout problem. The total of dividends paid by U.S. corporations amounts to about $100 billion per year, and the taxes on that are probably in the neighborhood of $30 billion. You are talking in those kind of numbers in a phaseout over a period of 4 to 6 years is probably realistic.

I think one of the questions that the committee has asked several times this morning is one that I would like to make a comment on, and that is how can the tax policy of the United States be improved without helping to keep entrenched management in place?

I would like to give an example. During a 5-year period, my own company's earnings and dividends to shareholders, the return to shareholders was 37 percent per year, 37 percent annual growth per year. We doubled our sales in that 5-year period, quadrupled our profits, had two stock splits and increased dividends four times.

Mr. Russo. What is the name of your company?

Mr. Baker. Arvin Industries.

At the end of that 5-year period, we were ranked No. 1 in the auto parts industry in the United States, and guess what? We had a knock on the door. A well-known raider wanted to buy our company.

Certainly, he was not wanting to throw out management, but at that time we had 19 percent debt, and it was very clear to him that we were not a leveraged company, and that he could, through asset stripping, make a great deal of money.

You have had some testimony this morning saying that there are studies that show perhaps those companies that are raided are poorly managed. You have had statements on the other side saying that perhaps the studies show that the best companies are the ones that are the most popular to the raiders.

My view is that the financial makeup of the balance sheet, the cash flow of the company are the two primary ingredients that determine when a hostile raid will be made, not management's performance.

I think if the Congress wants to improve the tax policy, they can eliminate raids on companies that are well-managed by reducing the double taxation of dividends. That takes all of the company's balance sheets and puts them in a neutral position.

We should not be penalized by having a 19-percent debt-to-equity ratio. Today, our debt-equity ratio is 51 percent. We are one of those companies that has leveraged up for the purpose of being less vulnerable to a hostile raid.

Mr. Russo. Do you think that is a good idea that you have had to do that?

Mr. Baker. I think as public policy, it is a very poor idea. I think we are driven by the tax regulations into a corner, and because of those tax regulations, American industry is leveraging up too much.

Mr. RUSSO. Don't you think as a result of what's happening in the Tax Code where we have this bias in favor of creating debt is one reason why the raiders want to come into your company when you only have a 19-percent debt ratio?

Mr. BAKER. Absolutely.

Mr. RUSSO. The reason it is because it called—for some reason makes a distinction between one and the other——

Mr. BAKER. That's right.

Mr. RUSSO [continuing]. And obviously favors that over equity.

Mr. BAKER. That's right.

Mr. RUSSO. And some of the proposals that we have before the committee are to balance that out.

The question is if we are to try to balance that out, how do we deal with it and pay for the provision that would then correct the inequity? There is one way that doesn't cost any money, and that is you just take away deductibility and interest. And that puts it on equal with equity.

Mr. BAKER. That's correct.

Mr. RUSSO. And you don't get a deduction for equity and you don't get a deduction for debt. Now, that makes it even. That's one way of doing it, and actually making money for the Treasury. What's wrong with that idea?

Mr. BAKER. If U.S. industry operated in a vacuum, that would be a good solution, an acceptable solution. But because we are in international markets today, and because of the taxation policies of other major industrialized countries, that policy will just further deteriorate the competitiveness of U.S. industry. We will be unable to raise capital. We will be unable to make acquisitions that are necessary, and we will be put at a very major competitive disadvantage.

Mr. RUSSO. But to go the other way to balance it off, which would be to create a deduction for equity, then we have to pay for that.

And so far, I haven't heard any solution as to how you pay for it. Even if you phase such a policy in, how would we pay for it?

Mr. BAKER. Well, I'm sure, Mr. Chairman, you are very well aware that many studies have shown that if we reduce the capital gains tax rate, we will increase the Federal tax revenue.

Mr. RUSSO. Well, there are just as many studies that show that in the long term that proposal loses money. So that is one reason why I don't like to use capital gains as the way of paying for things, because there's many studies on one side that say it raises revenue, and there are studies on the other side that say it doesn't.

Do you have any other ideas?

Mr. BAKER. No, sir.

Mr. RUSSO. Thank you.

Mr. Huard, in your testimony on page 5, you say the cost base of capital assets should be fully indexed for inflation.

Let me ask you this. If that's true then, should we then index debt and allow only a portion that's deductible for the payer on the same basis that we will not tax the full amount of the capital asset?

Mr. **Huard**. Well, I think if you do that, you have to play both sides of the street fairly. If you are going to disallow part of the interest deduction because of inflation indexing, the recipient of the interest ought to be able to exclude the comparable amount from income on the other side.

Indeed, that's a proposal which I think bears some serious examination. You may recall it was part of the 1984 original Treasury proposal on tax reform, the so-called Treasury 1 proposal.

Mr. **Russo**. Not many people in the business community liked Treasury 1, as I recall.

Mr. **Huard**. It was a lot better than what came after it.

Mr. **Russo**. Well, I thought Treasury 1 was so bad that all the "Eagles" took off in airplanes and arrived at National flooding the airport, to meet with the President and change Treasury 1 to Treasury 2. I thought 1 was the worst of all worlds.

Mr. **Huard**. Maybe from your perspective it wasn't.

Mr. **Russo**. Well, it was a more well-balanced attempt at reform than what replaced it. For instance, it had a significant deduction for dividends paid which did not ultimately survive in what became the Tax Reform Act of 1986.

Mr. **Huard**. You are never going to find a large tax reform proposal that runs several hundred pages that is going to be 100 percent satisfactory to any business group or any particular organization.

I will say that, on balance, from a point of view of structural integrity and theoretical consistency, Treasury 1 was frankly a lot better than any proposal which succeeded it.

Mr. **Russo**. Well, I guess maybe the depreciation schedules were more to your liking in Treasury 1 than what ultimately emerged. Would that be accurate.

Mr. **Huard**. No.

Mr. **Russo**. OK. But there are some things in Treasury 1 you didn't like, right?

Mr. **Huard**. Oh, sure. But that's going to be true of any multi-hundred-page tax reform proposal. Nobody is going to like everything that's in there.

Mr. **Russo**. But you would have preferred the enactment of Treasury 1 over the ultimate 1986 act?

Mr. **Huard**. Now, that's a hypothetical question, but I'll say yes.

Mr. **Russo**. OK. Well, I don't know how sincere you are about it. I'm just trying to see. Maybe we ought to go back and put some of the Treasury 1 reforms back into the laws. If there are some good things in there we should have done, maybe we should do them.

I'm just trying to hear from business what they think is wrong with the 1986 act. I guess we are a little bit far afield from LBO's but while I have you here, I might as well ask the question.

Mr. Hackett, let me ask you, on the basis of your experience as an appraiser in these transactions, are you concerned about the overall levels of debt which are placing cash full demands on assets in recent deals?

Mr. **Hackett**. Well, I am certainly concerned about the level of debt as respects any particular deal that we are evaluating because you have got to provide comfort not only on the best estimate of the terms of that debt and that particular transaction, but all the potentials that could occur upside or downside

Mr. **Russo**. Well, what happens if you have a downturn in the economy? How do you feel about that particular situation?

Mr. **Hackett**. Well, in the sensitivity testing that we do before we will render a particular opinion, be it fairness or solvency, we test for a reasonable downside to see if the deal will fly. If the deal will fly, given those sensitivity tests, it is a good solid deal. Otherwise, we wouldn't render any opinion.

So, I think, as Mr. Pickens has said, some deals are good, some aren't, and some are better, some are worse. But when you are rendering opinions, you are liable to have examined the potential of that downside.

Mr. **Russo**. But you are concerned about the overall level of debt, aren't you?

Mr. **Hackett**. Certainly.

Mr. **Russo**. Do you think it's good or bad?

Mr. **Hackett**. I haven't found anything yet in my studies to indicate there's severe damage.

Mr. **Russo**. So you think the level of debt that we're at today is not something to be concerned about?

Mr. **Hackett**. I think that good deals that are being done can support the debt load that they're carrying.

Mr. **Russo**. Have you ever recommended a deal as being a bad deal?

Mr. **Hackett**. Yes, sir. Yes.

Mr. **Russo**. Thank you.

Mr. Moody.

Mr. **Moody**. Thank you, Mr. Chairman.

I am sorry I was out of the room. We had a vote on, as you probably know.

However, I have read most of the testimony and found it very interesting.

Mr. Baker, your story about your own company I found particularly interesting. Did you leverage up just to ward off a takeover?

Mr. **Baker**. Well, my view is, Mr. Moody, that there's very little patient money left in the world today. There is a great deal of emphasis and pressure on CEO's for performance. Performance is generally translated into short-term performance.

Mr. **Moody**. Quarterly statements?

Mr. **Baker**. Quarterly statements. Pension fund management, all kinds of fund management has much more pressure on it for performance today than in years gone by. And we leveraged up for the distinct purpose of being less vulnerable.

Our balance sheet was very vulnerable. The statement that was made 10 years ago by the CEO at Textron, he said use your assets aggressively or someone else will. I think that statement was burned into the mind of every CEO in this country when he said that because that was at the basis of all the hostile raids that were going on.

Mr. **Moody**. And you further stated that you thought this was a bad thing. You would not have chosen to do this except for the pressures of the LBO possibility, is that correct?

Mr. Baker. Our company produces consumer durables. We should stay within a debt ratio of 35 to 40 percent.

Mr. Moody. But you are well over that now?

Mr. Baker. Yes, sir.

Mr. Moody. Then, you don't buy the argument that Mr. Pickens and others made in the first panel that all of this increases market efficiency. We were shaking out redundancy in the economy, and this counts as market control for management. It really forces management to do the long-term best thing for the company.

Mr. Baker. No. I think his point of view is one that's based on an opportunistic approach to regulation in tax law and asset management and asset evaluation, cash-flow, all those factors that point out those companies that are undervalued, not necessarily undermanaged.

I think if a company is undermanaged, then they should be vulnerable.

Mr. Moody. Well, why was your company undervalued? From what I hear from you, I would tend to believe that your company was not undermanaged, but was undervalued, at whatever price it was.

Why was it undervalued? If Mr. Pickens said the market was transparent, it knows what these assets are worth and it goes after them if they are undervalued.

Mr. Baker. Because the value of debt, the cost of debt is much less than the cost of equity and, therefore, a person going in and substituting debt for equity can take charge of a company at a much higher price than the market price, 30 to 40 percent premium.

Mr. Moody. So there was no other reason why it was undervalued. It wouldn't be undervalued if you had a neutral tax treatment.

Mr. Baker. That's exactly right.

Mr. Moody. So this so-called undervaluation you would maintain is not just a question of management not maximizing the return on assets? It's a question of managing those assets most efficiently. It's a question of the tax loss?

Mr. Baker. That's right.

Mr. Moody. Well, then why did the surge in LBO's come recently since the different tax treatment of debt and equity has been around for years? That's not new.

Mr. Baker. That's not new. I think, you know, if we go back to the sixties, United Technologies, Harry Gray was a very aggressive and a very hostile acquirer at that time. He acquired Carrier, Otis, and other companies. But, in doing so, he built a very strong, substantial corporation.

Today's hostile raiders are very greedy. They strip assets, and they have a different agenda. And I think that agenda is the one that is encouraged by our tax laws.

Mr. Moody. But the tax laws haven't changed. Has human nature changed? Are we more greedy today than we were in the 1960's?

Mr. Baker. Well, I think that's the case.

Mr. Moody. That's interesting. Now, your explanation of the LBO phenomena gets down to your interpretation of human motivation.

Mr. Baker. I'm sorry, it's what?

Mr. Moody. It gets down to motivation.

Mr. Baker. Yes, sir.

Mr. Moody. That's interesting.

Mr. Baker. I sit on several company boards and I have seen 11 hostile raids on the companies on whose boards I sit. And two of those were successful. The companies are not in existence obviously today. The companies have been shut down, employees laid off. It is really a devastation of a corporation to see assets stripped away the way some of the raiders do it.

Mr. Moody. But are those assets reemployed or redeployed somewhere else? They're not thrown away?

Mr. Baker. The raiders would like you to think that that's the case.

If you would go to Scovill in Waterbury, CT, today, you would see not only an empty corporate shell, but you would see an empty union hall, you would see everything that had been wiped out. There is no longer a Scovill Corp.

Scovill had the longest record of continuous dividends of any New York Stock Exchange company. They fell victim to a raider because of their debt ratio. Simple, clearly, that was the only reason.

Mr. Moody. Mr. Pickens isn't here to make his case, but assuming he were, I suppose he would say if those assets were producing value relative to cost, then it would have been irrational to close them down since, at the margin, more revenue than cost will be produced by keeping them open.

So why would they have been closed down?

Mr. Baker. Well, the various divisions of Scovill were sold to English companies, American companies, but the basic Scoville Corp. today no longer exists. The operating divisions were sold piecemeal, one by one.

Mr. Moody. But why was it rational to close them down after they were sold? Why would someone buy it and then close it?

Mr. Baker. Well, there is no intention of shutting it down when you buy it. If it is highly leveraged, you may have limited choices as to what you can do.

If there's a downturn——

Mr. Moody. So, is this one of the bad deals that Mr. Pickens described or do you think this is an inevitable outcome of LBO action?

Mr. Baker. Well, I think this is the kind of LBO action that's going on today. It represents a portion of the overall total activity. It's the kind that gets the most attention. It is not a good trend in the LBO activity in total. I think my point is that if we treat equity and debt alike, then the only companies that will be subject to hostile raids will be those that are poorly managed and are not fully utilizing their assets.

Mr. Moody. Well, we can't afford to do that, given the deficit structure we're in. By the way, let me state that I think the last 8 years has probably been the most fiscally irresponsible period in

American history because, among other things, it has precluded us from engaging in needed policy changes because they have short-term or intermediate-term revenue consequences we can't sustain. We were already in the hole this deep.

Mr. **Russo**. Would the gentleman yield at that point?

I think the bottom line is the Government decided to go into heavy debt versus heavy equity. And, fortunately, nobody is trying to take us over yet. [Laughter.]

Mr. **Moody**. In any event, given the fiscal policies of the last 8 years that put us in such a hole, since we can't do what you suggest. Do you have any other recommendations that we could employ?

Mr. **Baker**. Well, we say we can't do it. You know, what is the priority for making U.S. industry competitive in these new global markets that we operate in? Certainly it stands high on the agenda in Germany and Japan. And I think it's up to Congress to move our priority up higher on the list than it is today.

We are talking about a fairly major tax change that can be accomplished over a period of time at a fairly minimal annual cost. Now, is there not somewhere else that we can find $4 to $6 to $8 billion a year in which to make this happen, you give an additional competitive thrust to our industry?

Mr. **Moody**. Are you aware that Treasury was in here yesterday urging no action whatsoever. And they're supposed to be the guys with all the computers and the numbers and the analysts and the huge staffs of experts on what makes us more competitive and what we can afford or not afford to get there. They recommend basically zero action.

Mr. Brady was here awhile back and he addressed the same point you made, but he said he agreed—the only way you could pay for it would be to remove some of the deductibility on interest.

I don't think you would want that tradeoff, would you?

Mr. **Baker**. No, sir.

Mr. **Moody**. Short of that, financial leadership of the country, with all the analytic resources at its disposal, is saying do nothing.

Does your position on LBO's, which is pretty negative reflect the U.S. Chamber of Commerce? Is that their stand? Are you speaking for them?

Mr. **Baker**. No, we are not trying to restrict LBO activity.

Mr. **Moody**. But you said that the LBO activity has created some very deleterious effects on American competitiveness.

Mr. **Baker**. No. I'm saying that the way that we tax capital gains, the way that we tax dividends does lower our competitiveness.

Mr. **Moody**. But LBO's are the bridge between the tax regime, which has been around for a long, long time, and the current state which you decry. You say you don't want to limit LBO's and yet you're recommending policies that would cut back on LBO activity?

Mr. **Russo**. I think what the gentleman is saying, he would rather have the field level. And if it's level, then he would be in better shape. And he would get it level by making sure that you have the deduction for equity so equity and debt are treated equally.

Mr. **Moody**. OK. So you wouldn't take any steps other than the tax changes to do it?

Mr. **Baker**. That's right.

Mr. **Moody**. There's nothing else you would recommend doing?

Mr. **Baker**. Nothing else.

Mr. **Moody**. Just let it fly. We can't make the tax changes so let the plants you describe shut down.

Mr. **Baker**. That's right. It bothers me personally that a shareholder who owns a share for one day can vote about the future of a company. That does bother me.

But I don't see a good solution to that and, therefore, I don't recommend any changes. I think if we changed the tax policy, we'll make a major step forward.

Mr. **Moody**. Thank you.

Mr. **Russo**. The gentleman's time has expired.

The gentleman from—what is it, South or North Dakota? I forget. [Laughter.]

Mr. **Dorgan**. I thank the gentleman from Michigan.

Let me just make one quick point, Mr. Baker. The tone of your testimony is dramatically different than the tone of the chamber, at least as expressed by the president of the chamber on a television program that I participated in with him. That tone was there is no problem. This is capitalism at its best. And you let it all happen, and what happens is OK.

You say that some of it bothers you, but because you don't know what we should do about it, you recommend we do nothing.

Now, query: if it starts bothering you more and more because the activity accelerates more and more beyond today's level, is there a point at which it bothers you so much that you might suggest somebody do something about it?

Mr. **Baker**. Well, Mr. Dorgan, I suggest that we treat equity and debt the same.

Mr. **Dorgan**. I understand that. But as Mr. Moody said, that's not going to happen next year or, at least, it's not going to happen within the next 12 months. So I share some of those sympathies.

But if it doesn't happen and all of this activity continues, and it was to escalate to snowball, is there a point at which you would express sufficient concern to recommend public policy change?

Mr. **Baker**. Well, that's why I'm here today, to recommend a public policy and tax change.

Mr. **Dorgan**. I understand that. But Mr. Moody indicated, and I agree, that the cost of that is going to prohibit its being done in the next 12 months.

I'm just wondering, if that's not done to your satisfaction, or to mine, for example, and we continue to see an ever escalating pace of takeovers that have deleterious effects, would you exhibit some concern that would persuade you to pursue some other public policy measures or recommend to us to pursue some.

Mr. **Baker**. Well, our own State legislature passed a bill this year allowing corporate boards of directors to just say no. And that's a very important piece of legislation to permit boards to look at all offers and decide, based on long-term interests of the company, of those interests not only of the shareholders but of customers and suppliers and the community, et cetera, to take in all of those interests which the Delaware courts would not allow by their previous hearings, and gives corporations based in Indiana a much broader view, a long-term view of what's best for the corporation.

Mr. **Dorgan**. The testimony of all of the witnesses is excellent, and I apologize. I was over on the floor of the House and unable to be here to hear it.

I might observe finally in conclusion that my concern I expressed earlier in this committee session is for the long term as well.

You're a CEO, Mr. Baker, and my notion is that if you do all of the things that you probably ought to be doing for the long-term strengthening of the base of your company, some of them may not be in concert with those who make judgments about current value of assets which could imperil your company because if your assets are undervalued, there's somebody out there going to grab some junk bonds and run after you.

Does that give you pause?

Mr. **Baker**. Yes. I gave that example before you returned to the room. That's exactly what happened to our company.

Mr. **Dorgan**. So, if that's happening in other parts of the country, we have people who are maybe the exception in Boone Pickens. I assume you're an exception in Boone Pickens' notion? Are you one of the 80 percent or the 20 percent?

Mr. **Baker**. Well, I'm over 55.

Mr. **Dorgan**. But you're one of the 20 percent of the good ones in his estimation, and so you do all of the right things, or try to do the right things for the long term, and you imperil your company in terms of this being put in play for a hostile takeover because you may not have an absolute mirror of the reality in the judgment of the marketplace on the value of your assets.

Mr. **Baker**. Yes. I mentioned that we were ranked number one in our auto parts industry in performance, in total return to shareholders. But because we had low debt, we were subject to an unfriendly takeover.

Mr. **Dorgan**. And my point was that I think that's not good for the country.

Mr. **Baker**. That's not good at all.

Mr. **Dorgan**. Maybe we can't find a perfect public policy solution to that, I don't know, but I think that you and I agree on the notion that somehow does not serve this country's long-term interest. It may be that, in some instances, a company ought to be put in play, but the point I have in disagreement with Mr. Pickens is he suggests, on the one hand, the stockholders are awfully bright because stockholders in the aggregate are able to determine the exact value of a company.

Then he suggests they're not very bright at all because they can't deal with management at all. If they got bad management, they don't have the foggiest idea how to deal with bad management.

So it's hard to have it both ways on those questions, and I do think some of this activity at least is very detrimental to good companies trying to do a good job to plan for the long-term future.

Thank you very much.

Mr. **Russo**. I thank the gentleman from North Dakota.

Mr. Moody.

Mr. Moody. Thank you, Mr. Chairman, I would like to make a brief followup.

Mr. Huard, I didn't mean to bear down with Mr. Baker because I would be just as interested in your opinion as well Mr. Hackett's. But since I'm going to have lunch with Mr. Hackett, since he's from my district, he and I can discuss this later.

But just briefly, without reiterating all of the points that Mr. Baker made, do you have any comment on my questions or any reflections on the exchange Mr. Baker and I had?

Mr. Huard. Well, on the issue of how you pay for it, you know, I was very distressed in general by, you know, the concept that whenever you make a public policy change that loses tax revenue, you have to offset it with another public policy change. It raises tax revenue. You could just as easily offset it with other public policy changes that reduces spending.

You know, tax revenues in this country have been around 19 or 20 percent of GNP for the last three decades. And what's gone up a lot is Government outlays as a percentage of GNP. I don't find it written anywhere in cement that any time you make a change that loses revenue, you have to offset it with a change that raises revenue. You can just as easily offset it with an expenditure reduction.

Mr. Moody. Mr. Huard, pardon me——

Mr. Russo. Read my lips.

Mr. Moody. Pardon me for interrupting you, but you——

Mr. Russo. That's the problem we have.

Mr. Moody. You know, we put the Reagan budgets out on the floor of the House and the Senate to test that very proposition. And they got—not only a minority—but a tiny minority of Republican, not to mention Democratic votes.

Unfortunately, Government spending for good or evil is sticky downward. You develop constituencies that like to keep the flows coming. Since over half of the budget is now entitlements, and another 16 percent is interest payments, and the rest is discretionary spending which has frankly, except in military, been cut, a downward movement in the budget by political consensus on either side of the aisle has not occurred.

So that is why it is not realistic to say, well, we will just offset the divided exchange by cuts in spending. That might be great. But I think it's even less likely, if I could say so, than giving a tax revenue item to——

Mr. Dorgan. Would you yield on that point?

Mr. Moody. Sure.

Mr. Dorgan. Mr. Huard, has the National Association of Manufacturing provided Congress with its recommendation of specifically where spending cuts might be accomplished to deal with this and other issues?

Mr. Huard. We've testified numerous time in past years. We suggested, among other things, that entitlement should not be a sacred cow, the cost of living adjustment should not be 100 percent indexed to inflation.

Now, Mr. Moody tells me that the mood of the Congress is not to accept any of these things. Well, that's fine. But we have made those recommendations.

Mr. Dorgan. And so, to translate, entitlement is not a sacred cow, that means suggesting delaying the cost of living increase for Social Security, for example?

Mr. Huard. That's right.

Mr. Dorgan. Do you understand that this year alone, we'll collect $68 billion more in Social Security taxes than is needed for outlays in Social Security?

Mr. Huard. Oh, I know. I'm part of the baby boom. That's supposed to pay for my benefits.

Mr. Dorgan. And that's supposed to be for savings, isn't it?

Mr. Huard. Well, I don't know. It's basically you're buying Government IOU's. And I guess when I turn 65 and they pay my benefit, they have to saddle my kids with a 40-percent FICA rate.

Mr. Dorgan. Do you think that if we cut Social Security, we have an obligation to cut the dedicated tax that's used to pay for it?

Mr. Huard. No.

Mr. Dorgan. So that we would collect the Social Security tax to pay for defense, is that what you're suggesting?

Mr. Huard. You're not paying for defense with it.

Mr. Moody. But you're paying for general government—in this case the cost of the change in dividend treatment.

Can you imagine the popularity on the floor of the House saying now we want to cut the tax on dividends, and we are going to take it by taking 1 percent away from the COLA's for senior citizens.

That may sound great but politically its not realistic. I'm saying this as a Democrat who has voted for freezes in Social Security, something not many Democrats do. But we're in never, never land if we think we can pay for a dividend change with cuts in Social Security COLA's.

Mr. Huard. Well, that may be true, in which case I would say that if you're not going to change the treatment of dividends, that you just leave it alone. I mean two wrongs are not going to make a right.

I mean right now you have a system where you treat interest properly and dividends improperly. Treating them both improperly is not going to solve your problem.

The propensity of the Congress when they go into the Tax Code to make changes to achieve social goals is to enact cures that are worse than the disease, Section 89 being only one notable example.

I don't think, you know, going in to try to define hostile versus nonhostile, good debt versus bad debt, junk bonds versus nonjunk bonds is going to be a productive exercise.

Mr. Moody. OK. But I guess what Mr. Dorgan was trying to get from you, Mr. Huard, with all respect, is if we can't cut the spending on the COLA's or something else, and we have to do it within the context of a balanced budget deficit controlled context, then we have to reach somewhere else on the revenue side for the offset.

Do you have any recommendations in that regard?

Mr. Huard. No. I suggest if you can't do it within the context of the revenue code without any offsetting revenue increase, then don't do it at all. There are other areas where you can look.

You know, I'm not saying this is not a problem. But there's the whole area of SEC regulations and tenders. It seems to me there's the whole issue of whether, you know, the Antitrust Division of the Justice Department has had a "gone fishing" sign on the door for the last 8 years.

Mr. **Dorgan**. That's not question.

Mr. **Huard**. I'm just saying that there approaches to the problems of excessive takeover activity and excessive debt levels in LBO's that don't involve using the Internal Revenue Code. I think that those approaches deserve some careful study and consideration.

Now, some of that is beyond the scope of this committee so obviously I can't recommend that you gentlemen do anything there. But there are areas that need to be looked into outside the Internal Revenue Code.

Mr. **Moody**. OK. Thank you. This has been helpful, and you do recommend that we do look at those other reasons?

Mr. **Huard**. Oh, absolutely.

Mr. **Moody**. Thank you.

Mr. **Russo**. I want to thank the panel. I appreciate your spirited responses to some of the questions.

Our next panel consists of James Merle Carter, secretary and general tax counsel, of ICI Americas, of Wilmington, DE, and Andrew Galef, president, Spectrum Group, Inc., and chairman of the board for MagneTek, Inc., Warnaco, Inc., and Exide Corp.

Mr. Carter, you will be the first to proceed and, as with all other witnesses, your entire statement will be made a part of the record and to the extent that you can summarize and do it in 5 minutes, we would appreciate it.

STATEMENT OF JAMES MERLE CARTER, SECRETARY, ORGANIZATION FOR FAIR TREATMENT OF INTERNATIONAL INVESTMENT, INC., AND GENERAL TAX COUNSEL, ICI AMERICAS, WILMINGTON, DE

Mr. **Carter**. I thank the committee for this opportunity to speak on behalf of the Organization for Fair Treatment of International Investments. That is a group that is composed of the U.S. subsidiaries of a number of major foreign corporations. These are U.S. companies that employ over 100,000 U.S. citizens in the automotive, electronics, chemicals, consumer goods, food products, metallurgy, and pharmaceutical industries.

Our remarks today address the specific sector of the proposals that would treat U.S. companies such as ourselves on a different footing from domestically owned corporations, largely because of what our shareholders may be doing in other countries. The particular problem that we have with the first proposal is that it would attribute gross income to a U.S. company based upon interest rates or borrowings that a foreign parent or affiliate would engage in overseas not necessarily related to anything that transpires in the United States.

The way the proposal reads the U.S. company would be penalized because a foreign parent borrowed at a high interest rate to make a foreign acquisition. This involves, and I think the Treasury testimony yesterday pointed this out, a very difficult compliance problem for the United States. It would involve treaty violations, and it would almost certainly invoke retaliation from foreign countries.

I think it has to be kept in mind that the U.S. investment in foreign countries is greater than the foreign investment in the United States, and as a practical matter the United States has a lot to lose if we are the ones who start some kind of a trade or penalty war which is going to hurt U.S. investment abroad.

The particular point that is made is that you get an unfair advantage to the foreign country I don't think is valid because no foreign company can afford to borrow at let's say the junk bond high interest rate in Germany, contribute that as capital to a United States subsidiary to make a United States acquisition and then have no tax deductible earnings stream from which to pay the interest rate it has incurred.

There may be some instances where that would work, but I can think of very few that that would be a successful economic technique. As a result, we don't think that the foreign shareholders have an advantage in that regard. Whenever our members have had to make acquisitions, we normally have to make the acquisition, if we borrow money to do so we have to do it in our own name, so we would be entitled as U.S. taxpaying companies to get that interest deduction. Otherwise, we couldn't afford to do it.

Now the point has been made here by some of the other speakers, if there is a problem with takeover activity and if there is some need for a social or public purpose to restrict it, it ought not to be done through the internal revenue laws. Because every time you make that kind of a change in the internal revenue laws, you open up a lot of other avenues for manipulation of finances that don't necessarily produce the result that you are trying to seek.

The question I think was asked, is "well what has happened in the last 15 or 20 years that produces all of this kind of activity?" I think the reason for it is, inflation is one, the huge Federal deficit is another, and the large foreign trade deficit is yet another. When you take those factors together you are now producing a climate, which Wall Street recently discovered, as to how you can engage in economic engineering, financial engineering to produce profits without actually producing goods. That may be a problem but I don't think that is going to be addressed or remedied through changing the tax laws by taking away the interest deduction.

As I think is also being said, and I would like to repeat it again: If you cannot do something to reduce the heavy bias that the tax law has in favor of debt over equity, then you are better off to do nothing at all. At least leave the structure in place and try to work for other solutions, perhaps other areas in which revenue can be raised, if that seems to be the real point here.

Certainly the restriction on portfolio interest debt, or putting the 30-percent tax on portfolio interest debt is not going to help U.S. business. It isn't going to help foreign-owned U.S. business. It isn't going to help domestically owned U.S. business because it is cutting off access to capital which U.S. business badly needs. That really is the root problem of all of these problems. It tends to restrict the access of U.S. businesses, whether foreign owned or domestic owned, to the sources of capital which are badly needed.

I think all of the—the earning stripping provision is another one that tends to do the same thing. There is no evidence that foreign shareholders engage in so-called earning strippings, and that is for the reason that they pay taxes as high or higher in their own countries. There is no advantage to taking the interest out of the U.S. company and pay a tax on it in their own country. So the fact of the matter is capital in any corporation has to be a balance of both debt and equity. We all recognize that, and we hope that this committee will not to try to do something in terms of what is deemed to be an undesirable activity by changing the tax laws that is going to make it more difficult for all businesses to operate and to get the necessary capital they need for their operations.

Actually, the rest of my comments were just a summary and that really covers the principal points I wanted to make. Thank you.

[The statement of Mr. Carter follows:]

STATEMENT OF JAMES MERLE CARTER, SECRETARY, ORGANIZATION FOR FAIR TREATMENT OF INTERNATIONAL INVESTMENT, INC.

My name is James Merle Carter, testifying as Secretary of OFTII, a U.S. trade group the membership of which consists exclusively of domestic corporations owned or controlled by foreign parent companies. OFTII members collectively employ more than 100,000 United States citizens in manufacturing and distributing products covering virtually the spectrum of modern technology, including automotive, electronics, chemicals, consumer goods, food products, metallurgy, and pharmaceuticals. A list of OFTII members who support this statement is appended.

OFTII, in general, is opposed to any proposal that would penalize a domestic company in respect of activities conducted overseas by foreign affiliates having little connection with business conducted in the U.S. The most offensive of these proposals is E1, that would allocate to the U.S. affiliate as gross income "excess" interest incurred by a foreign parent or affiliate in respect of its own operations outside the U.S. No international business would have the resources to borrow substantial sums of foreign money at high interest rates, contribute that money as capital to a domestic corporation to make a U.S. acquisition, and expect to repay the debt from its own foreign earnings, unsupported by any tax deductible income stream from the U.S. acquisition. Under present law, the debt free U.S. company would incur maximum U.S. tax on its income from the acquisition and receive no tax relief for dividends paid to its foreign parent. Only if the tax rate in the parent company's domicile equalled or exceeded combined U.S. federal and State income taxes in addition to the U.S. withholding tax on the dividend could there even be full use of tax credits on that income stream. This fact, coupled with the "excess" interest rate on the initial borrowing would make such a financing plan entirely unattractive.

The E1 proposal is a repudiation of the "arm's length" principle of taxation that is embodied in the Internal Revenue Code and in every treaty for the prevention of double taxation that the U.S. has negotiated with our foreign trading partners. The proposal seeks to impose a U.S. financial standard on entities that have no business operations in the United States and, if adopted, is certain to provoke retaliation against foreign subsidiaries of U.S. businesses. According to figures recently furnished to the Congress, U.S. investment abroad still exceeds substantially the aggregate foreign investment in the U.S. The U.S. has much to lose if we start a fiscal war with our foreign trading partner nations.

It is unlikely that an interest rate cap on U.S. corporations would raise much tax revenue since its obvious purpose is to restrict the use of "junk bonds" for acquisitions. If this end is completely successful, no additional tax revenue would result. OFTII does not think that it makes social or economic sense to use the tax laws to regulate or prohibit legitimate corporate and financial activities. Should it become necessary to restrict merger and takeover activity, and OFTII sees little evidence that restriction is needed at present, restriction should come through the securities laws, not the tax code. In no event should the U.S. have a rule that imposes a tax penalty on a U.S. subsidiary of a foreign company when the foreign company borrows foreign money to make a foreign acquisition. The U.S. has no legitimate interest in such a transaction unless the borrowed funds are actually contributed to the U.S. subsidiary so that it can make a U.S. acquisition.

It should be kept in mind from the outset that Mr. Milken didn't create the U.S. tax system's most powerful inducement for LBOs. The favored status of debt over equity existed for many years before Wall Street learned how to take maximum advantage of it. It hardly needs to be repeated that the Scylla and Charybdis of the U.S. economy are the federal deficit and the foreign trade imbalance. Neither peril will be averted by limiting access of U.S. business to capital, irrespective of whether that business is foreign owned or domestically owned.

The point has been made over and over that the prime force behind high debt: equity ratios for U.S. corporations is the excessive cost of equity compared to the cost of debt, even "junk bond" debt. A corporation must forever distribute nondeductible, previously taxed, earnings in respect of equity. Debt, at least, is eventually retired. Under the present tax regime, interest is not only deductible, but concomitantly reduces earnings available for distribution, making new equity even less attractive to potential investors. If it is desired to decrease the attractiveness of debt financing and increase the appeal of equity, the obvious answer is to give corporations at least a partial deduction for paying dividends, as is proposed in C3. Consideration should also be given to reducing the rate of capital gains tax on capital stock. It should not be overlooked in this regard that there is already a "compensating" tax imposed on foreign shareholders, known as the withholding tax. Where that rate has been reduced by treaty, any unilateral increase in withholding will be a violation of that treaty and will surely provoke reciprocal treatment that ultimately will greatly harm the U.S. economy as well as the world economy. If additional "compensating" taxes are to be imposed on foreign shareholders in respect of this proposal, it must be done through the treaty process so as to assure reciprocal and evenhanded treatment for both inbound and outbound investments.

The proposal (E2) to reinstate the withholding tax on portfolio debt interest payable to foreign persons has no economic basis, and will certainly do nothing to reduce the trade deficit. The tax was repealed in the first place to allow U.S. businesses direct access to the Eurobond market without the need to use intervening Netherlands Antilles financing subsidiaries. Those were valid reasons in 1984 and remain valid reasons today. The principal concern of OFTII members with the proposal, however, is its recommended disregard of long standing treaties and the fact that foreign retaliation is inevitable. U.S. businesses, including both domestic and foreign owned U.S. businesses, still need access to the Eurobond Market. Where should the huge dollar surpluses being developed abroad as a result of the U.S. trade deficit be utilized if not to develop business in the U.S. and as a source of capital for U.S. enterprises? These dollar surpluses will not be diminished by restricting the ability of U.S. business to expand and to export by choking off access to capital.

As previously noted, the way to convert capital from debt to equity is to create a favorable climate for equity, not to make all capital more difficult to obtain. Giving U.S. corporations a partial deduction for dividends paid would militate heavily in favor of equity. Reduction of the capital gains rate on capital stock would similarly enhance access to equity capital. Were U.S. equity investment more favorably treated under the tax laws than at present, there would be less demand for debt financing, whether of U.S. or foreign origin.

Revival of the old "earnings stripping" provision (E3) appears to be merely another attempt to restrict foreign investment in the U.S., not to raise tax revenue. This proposal, furthermore, has little connection with the LBO and junk bonds issue. Internal Revenue Code Section 482 already prevents a related foreign company from receiving interest in excess of an arm's length rate. Why is it believed necessary to impose additional restrictions? Particularly invidious is the proposal to gear the restriction to taxable income. Suppose the domestic corporation has a bad year or a large casualty loss? Should it be penalized further by a tax on nonexistent income? The basic premise of the proposal is demonstrably in error. A related foreign company is not "tax-exempt" because interest payments to it are free of withholding tax. No OECD nation taxes dividends less favorably than interest. There is, consequently, no incentive for investors from treaty nations to prefer debt to equity for their U.S. investments since earnings on both are fully taxed in the home jurisdiction. This proposal, standing alone, would tend to force foreign investors into the U.S. "junk bond" market and would produce little or no tax revenue within a year or two after the debtor companies restructure their debts. In concert with the other proposals, it can only be viewed as a blatant and ill conceived attempt to restrict foreign capital inflows. The U.S. needs capital and, if it cannot be supplied domestically because of federal deficits and trade imbalances created by our own spending habits, it must come from outside. Restricting access to that capital will merely weaken the U.S. economy.

The purpose of the proposal (E4) to amortize goodwill is altogether unclear and does not appear to have relevance to LBO issues. The December 1987 GAO Briefing report on amortization of goodwill stated that, while 3 countries (Canada, Japan, and West Germany) permitted some tax deduction for goodwill, "it would be difficult to draw any firm conclusions about the consequences of tax treatment of goodwill without studying each country's entire tax structure." OFTII is unaware that such a study has been undertaken and it is strongly urged that this proposal be tabled until its operation and likely effects are better understood. The proposal would appear to call for increase in the book/tax difference income subject to Alternative Minimum

Tax, and, hence, might not be of any benefit to anyone. The Committee should focus on modifying or, at least, simplifying the AMT instead of creating another complex relief provision that is likely to have unanticipated consequences. As a representative of U.S corporations, OFTII doesn't reject any tax benefits, but does express grave doubt that this one will actually prove beneficial.

The proposal to establish a situs rule for stock (E5) involves questionable economics. Some nations, notably India, Japan, Mexico, and some South American countries have situs rules but do not recharacterize the gain as dividends. The effect is to require the domestic company either to collect the tax on gain or to obtain tax clearance before a transfer in registration of capital shares can take place. Treatment of gain derived by foreign persons as dividends would violate the anti-discrimination provisions of numerous tax treaties, including the U.S. and OECD model treaties. It would encourage foreign countries to discriminate against U.S. companies, particularly if the new rules override existing treaties. The U.S. should not be in the position of encouraging proliferation of intermediate holding companies and situs rules that adversely affect U.S. shareholders of foreign companies. There is no impact on the U.S. Treasury or the U.S. economy if a foreign national makes a gain by selling a U.S. corporation's capital stock to another foreign national. The stock is still held abroad and U.S. withholding and other taxes are still applied to distributions in respect of that stock. If, however, a U.S. citizen sells stock in a foreign company located in a situs rule country, the U.S. Treasury loses the tax on sale to the extent a foreign tax credit is applicable. It is OFTII's view that the nation in which a taxpayer holds citizenship or permanently resides should have priority in taxing sales of capital stock. The U.S. should endeavor to extend this rule rather than abandon it and, in no case, should the U.S. arbitrarily recharacterize gain to discriminate against foreign investors.

In summary, OFTII members offer themselves as examples of the beneficial effects of substantial foreign investment in the U.S. economy. Jobs for U.S. citizens are created; goods for domestic consumption and export are manufactured here; technology is imported and utilized here. Exported technology brings in substantial, taxable, licence royalties. Few hostile takeovers by foreign investors have occurred. For the most part, State development authorities have begged for foreign capital to invest and have offered local incentives to do so. If the federal government discovers that some kind of an abuse is taking place, there is an obligation to correct it. OFTII knows of no abuses or detrimental effects caused by foreign investment in U.S. industries. It is our belief, and the belief of our U.S. citizen employees, of which this speaker is one, that the benefits of encouraging foreign capital far outweigh any harm that has been suggested. This Committee is, therefore, respectfully urged to reject proposals that would simply penalize and discourage foreign capital investment in U.S. industry. There are, at present, no clear alternatives for the U.S. economy unless and until we can tame the twin deficit monsters, federal and trade. Whatever rules are proposed to encourage equity infusion into U.S. industry should not be tailored to deny access to the great pool of foreign capital that our own spending habits have created.

Were the U.S. to attempt to restrict foreign investment at this time, it would create havoc in our financial markets. Equity prices would be depressed because there would be less demand for shares of U.S. companies by barring an important bloc of potential buyers. There would be a sharp decline in the dollar since there would be no outlet for foreign held dollars. Interest rates would increase, not decrease. The way to decrease foreign investment, if that is a desirable object, is to reduce the trade deficit. The most important step in reducing the trade deficit is reducing the budget deficit. That should be the focus of this Committee. OFTII does not believe that any of the proposals that are the subject of today's hearing will have a significant impact on the budget deficit. Taxes may have to be raised, but tax measures that seek to regulate the balance between debt and equity for non-revenue purposes aren't going to add anything to the U.S. economy except confusion and upheaval in the stock market.

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Siemens Capital Corporation
Sony Corporation of America
Thorne-EMI (USA), Inc.
Unilever United States
Volkswagen of America, Inc.
Volvo of North America Corporation

Mr. Russo. Thank you very much, Mr. Carter.
Mr. Galef.

STATEMENT OF ANDREW G. GALEF, PRESIDENT, SPECTRUM GROUP, INC., AND CHAIRMAN OF THE BOARD, MAGNETEK, INC., WARNACO, INC., AND EXIDE CORP., ON BEHALF OF ALLIANCE FOR CAPITAL ACCESS

Mr. Galef. Yes. Thank you. Good afternoon.

My name is Andrew Galef. I am the president of the Spectrum Group, which is a private investment firm based in Los Angeles. I am also chairman of the board of MagneTek, a Fortune 500 company. I am also chairman of Warnaco, another Fortune 500 company, and chairman of the Exide Corp., which would be a Fortune 500 company if its securities were publicly traded.

I am appearing here today on behalf of the Alliance for Capital Access, an association of growing midsized companies that have used high yield bonds to finance their growth. Many of the proposals before you today accept the assumption that LBO's, leveraged acquisitions and the issuance of debt need to be restrained by changes in the tax laws.

But rather than solving a perceived problem, I believe that the actions to restrict debt financing will create a new and very real problem—a much higher cost of capital for the growing and midsized companies on which this country depends for its long-term economic strength.

Obviously, there have been and will be abuses in the LBO process, but no one has yet developed an effective way to distinguish legislatively between good transactions and bad transactions. Thus, while some options may curb LBO's that harm workers, shareholders and communities, you can be sure that they will also chill hundreds of very positive transactions that contribute to a stronger, more competitive America.

Let me state at the outset that I believe the current treatment of interest is sound as a matter of tax policy, and the treatment of equity is wrong. However, proposals to correct partially the equity problem by abandoning the sound treatment of interest makes no sense to me.

Appendix A with my statement contains a detailed discussion of some of the specific options that were listed in your April 12 press release. In these remarks, I want to discuss the real world impact of proposals that link some form of dividend relief with new limits on the interest deduction on those of us who run growing businesses that must raise capital based on the decisions that you make.

Options that incorporate dividend relief sound appealing, especially when advocates talk about a revenue neutral approach where all businesses lose a bit and gain a bit. Unfortunately, in the world in which I operate life is never a zero sum gain. There is certain realities of corporate finance that are immutable. One of these is that growing and midsized companies once they pass the initial venture capital phase rely more heavily on debt to finance their growth than do larger companies. These companies always have and always will rely disproportionately on debt for three very good reasons.

First, it is much harder for them to raise equity than it is for the established Fortune 500 firms. Second, they don't want to or can't afford to pay the staggeringly high returns demanded by equity holders. And, third, they don't want their business decisions guided by the short term, quarter-to-quarter mindset of Wall Street.

The fact that growing and midsized companies rely more heavily on debt capital to finance their business operations is supported by data developed by Standard & Poor's Compustat, a database of 12,000 companies. Compustat shows that the 5,500 companies, largest companies with sales under $1 billion have an average debt-to-market capitalization ratio of nearly 5 to 1, nearly 50 percent greater than the average debt-to-market capitalization ratio of the 550 largest firms in America. Other data further supports this finding. According to IDD Information Services, between January 1, 1987, and May 1, 1989, one-half of all common stock issued by American companies, 28 billion, came from the large U.S. companies with sales in excess of $1 billion. The other 28 billion was issued by more than 5,500 companies with sales under $1 billion. In other words, 10 percent of the companies in America issued one-half of the common stock.

These figures suggest that growing companies tend to carry more debt and issue less equity than large companies. It follows then that the practical reality of any proposal that limits the introduction on corporate debt is that it will disproportionately benefit the 550 largest companies and hurt everybody else.

Who will benefit from any proposal that uses revenue raised by limiting interest deductibility to provide dividend relief. Again the data is clear. The winners will be big business. According to Compustat, the 550 large companies with sales over $1 billion paid nearly $67 billion in dividends in 1988, or 86 percent of all dividends paid by American companies. The data also shows that the companies with sales of $1 billion or less paid only $11.2 billion in dividends. In other words, the handful of small and midsized companies that do issue stock tend not to pay dividends.

There is a good reason why they don't pay dividends, and even if you grant some form of limited dividend relief. Small and midsized companies reinvest their earnings in new factories, new technology, and new marketing. They can do so because their equity holders are more long-term oriented, preferring to profit through the growth and success of the business rather than receiving short-term gratification through dividend payments.

In contrast, mature, cash-rich businesses by that very fact tend to invest less in the growth of their firms and pay dividends instead to please the short-term demand of institutional investors.

I believe strongly that a policy that encourages companies to pay dividends rather than reinvest earnings may not be in the best long-term interests of a competitive America.

All this data adds up to one conclusion. A revenue neutral tax increase for debt capitalized ventures, offset by a tax benefit for dividend payments, will constitute a direct transfer of wealth from America's small and midsized companies to the 550 largest and most mature businesses in America. It is a tax break for big business financed on the backs of growing midsized companies who rely on debt financing, and when they do issue stock tend not to pay dividends.

Congress should not adopt a policy that so clearly benefits a small class of companies at the expense of so many others, especially when in general these larger firms, frankly, are not providing the growth, jobs or industrial creativity that we need in this country.

The last point is illustrated by additional data from Compustat showing that the firms that pay dividends tend to have slower growth rates than those that did not. Over 42 percent of the dividends paid, $34 billion, came from companies whose average growth rate has been less than 5 percent over the last 5 years. In contrast, companies with the highest 5-year growth rates paid only $6.7 billion of the dividends in 1988.

Mr. Chairman, I am not an academician or a tax lawyer. I manage companies. But these statistics should give you and this committee great pause before you pursue these proposals. At the very least they tell us be careful. This is not a zero sum game. Let's look very carefully before we take a step that will raise the cost of capital for the very companies leading America's economic renaissance.

The alliance will be happy to work with you and the staff to further develop this data to determine the distributional impact of some of the proposals you are considering. Of course, in the end all data is abstract. But my own experience as both chief executive and chief operating officer of major American growth companies deeply involved in industries facing tough international competition bears witness to the fact that limits on debt financing will starve dynamic competitive companies of the capital that they need to grow.

Five years ago, MagneTek, which is headquartered in Los Angeles, was just an idea. In 1988, we broke into the Fortune 500 with worldwide sales of $910 million and a 49-percent growth rate. We achieved most of this remarkable growth through leveraged acquisitions. Over the past 5 years we bought the electrical equipment manufacturing divisions of several Fortune 500 companies, one from the Magnetics Group of Litton Industries, the Universal Manufacturing Division of Frawley Northwest, National Electric Coil from Cooper Industries, and Century Electric from Gould, Inc.

In the process MagneTek has become a national and world leader in the production of lighting ballast, motors, generators, power supplies, and other electrical products for both commercial and military use.

MagneTek has not only acquired orphan divisions from conglomerates and reinvigorated them, we have also created over 650 new jobs nationwide, currently employing over 13,000 people. In our capital expenditures, building of new plants and purchases of new equipment have risen from $4 million in 1986 to $25 million in 1988. MagneTek's debt-to-equity ratio today is nearly 10 to 1. We carry $410 million in debt and paid interest of over $40 million in 1988. We paid only $3 million in dividends, all of it on preferred stock.

Our shareholders understand that we are reinvesting virtually every dime of free capital to make the company grow. They do not expect short-term returns.

The Warnaco story is similar. The company is one of the largest clothing manufacturers in the Nation. Warnaco's products are marketed under brand names such as Christian Dior, Chaps by Ralph Lauren, White Stag, Hathaway, Warner's, Olga, and Speedo. It has dual headquarters, in New York and Los Angeles.

In 1986, we acquired Warnaco through a $550 million leveraged buyout. Since the buyout, Warnaco has been transformed from what the New York Times called a complacent insular company into a strong competitor in the domestic retail markets. Our company sales in 1988 were up 11 percent over prebuyout sales, and our operating profits have increased over 67 percent over the same period.

At the same time that we have improved Warnaco's operating efficiency, we have created over 1,500 new jobs in North America and the Caribbean Basin, bringing back production formerly performed in the Far East. We have increased the capital expenditures and new product development budgets for the company in each of the past 3 years.

The company has $551 million in debt outstanding, pays interest of $72 million a year, and has paid $5 million in dividends, all on preferred stock.

You asked in your release for comments on how proposals to pare back the interest deduction would affect the ability of companies to compete. Let me put simply, if inelegantly, you would stifle the progress of a company like MagneTek, which in just 5 years has risen to challenge our foreign competitors. You would seriously inhibit the growth of a company like Warnaco, one of a handful of American apparel manufacturers successfully competing with Asian producers. Almost without exception my foreign competitors have a much cheaper cost of capital than I do. If you reduce the interest deduction, you will make it even harder for me to keep up with them. Dividend relief at the expense of the interest deduction may produce some positive benefits for some companies, but I can tell you this for sure. It will certainly make it harder for my companies to keep pace with our foreign competitors. I hope that is a price you decide is too costly for this country to pay.

Thank you.

Mr. Russo. Thank you very much, Mr. Galef.

[The statement of Mr. Galef follows:]

ACA

Alliance For Capital Access

1919 Pennsylvania Avenue, N.W. Suite 701
Washington, DC 20006
202/429-9628

TESTIMONY OF MR. ANDREW G. GALEF
PRESIDENT
SPECTRUM GROUP, INC.
ON BEHALF OF
THE ALLIANCE FOR CAPITAL ACCESS
BEFORE THE
WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

MAY 17, 1989

Good afternoon. My name is Andrew Galef, and I am President of The Spectrum Group, a private investment firm based in Los Angeles. I am also Chairman of the Board of MagneTek, Inc., a Fortune 500 company, Chairman of Warnaco, Inc., another Fortune 500 company, and Chairman of Exide Corporation, which would be a Fortune 500 company if its securities were publicly traded.

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Many of the proposals before you today accept the assumption that LBOs, leveraged acquisitions and the issuance of debt need to be restrained by changes in the tax laws. But rather than solving a perceived "problem," I believe that the options to restrict debt financing will create a new and very real problem: a sharply higher cost of capital for the growing and mid-sized companies on which this country depends for its long term economic strength.

Obviously, there have been, and will be, abuses in the LBO process. But no one has yet developed an effective way to distinguish legislatively between "good" transactions and "bad" transactions. Thus, while some options may curb LBOs that harm workers, shareholders, and communities, you can be sure that they will also chill hundreds of very positive transactions that contribute to a stronger, more competitive America.

Let me state at the outset that I believe the current treatment of interest is sound as a matter of tax policy and the treatment of equity is wrong. However, proposals to correct partially the equity problem by abandoning the sound treatment of interest make no sense.

Appendix A of my statement contains a detailed discussion of some specific options listed in the April 12 release. In these remarks, I want to discuss the real world impact of proposals that link some form of "dividend relief" with new limits on the interest deduction on those of us who run growing businesses that must raise capital based on the decisions you make.

Options that incorporate dividend relief sound appealing, especially when advocates talk about a "revenue neutral" approach where all businesses lose a bit and gain a bit. Unfortunately, in the world in which I operate, life is not a zero sum game. There are certain realities of corporate finance that are immutable. One of these is that growing and mid-sized companies, once they pass the initial venture capital phase, rely more heavily on debt to finance their growth than larger companies. These companies always have and always will rely disproportionately on debt, for three very good reasons: 1) it is much harder for them to raise equity than it is for established Fortune 500 firms; 2) they don't want to, or cannot afford to, pay the staggeringly high returns demanded by equity holders; and, 3) they don't want their business decisions guided by the short-term, quarter-to-quarter mindset of Wall Street.

The fact that growing and mid-sized companies rely more heavily on debt capital to finance their business operations is supported by data developed by Standard & Poor's Compustat, a data base of 12,000 companies. Compustat shows that the 5,500 companies with sales under $1 billion have an average debt to market capitalization ratio of nearly 5 to 1, nearly 50 percent greater than the average debt to market capitalization ratio of the 556 largest firms in America.

Other data further supports this finding. According to IDD Information Services, between January 1, 1987 and May 1, 1989, one-half of all common stock issued by American companies, $28 billion, came from the large U.S. companies with sales in excess of $1 billion. The other $28 billion was issued by the more than 5,500 companies with sales under $1 billion. In other words, 10 percent of the companies in America issued about one-half of all the common stock.

These figures suggest that growing companies tend to carry more debt and issue less equity than large companies. It follows, then, that the practical reality, of any proposal that limits the interest deduction on corporate debt is that it will disproportionately benefit the 556 largest companies and hurt all others.

Who will benefit from any proposal that uses revenue raised by limiting interest deductibility to provide dividend relief? Again, the data is clear. The big winners will be big business. According to Compustat, the 556 large companies with sales over $1 billion paid nearly $67 billion in dividends in 1988, or 86 percent of all dividends paid by American companies. The data also shows that the companies with sales of $1 billion or less paid only $11.2 billion in dividends. In other words, the handful of small and mid-sized companies that do issue stock tend not to pay dividends.

There is a good explanation for why smaller companies don't pay dividends -- and won't even if you grant some form of limited dividend relief. Small and mid-sized companies tend to reinvest their earnings into new factories, new technology, and new marketing techniques. They can do so because their equity holders are more long-term oriented, preferring to profit through the growth and success of the business, rather than receiving short-term gratification through dividend payments. In contrast, mature, cash-rich businesses, by that very fact, tend to invest less in the growth of their firms and pay dividends instead to please the short-term demands of institutional investors. I believe strongly that a policy that encourages companies to pay dividends rather than reinvest earnings may not be in the best long term interests of a competitive America.

All this data adds up to one conclusion: a "revenue neutral" tax increase for debt capitalized ventures offset by a tax benefit for dividend payments will constitute a direct transfer of wealth from America's small and mid-sized companies to the 550 largest and most mature businesses in America. It is a tax break for big business financed on the backs of growing, mid-sized companies who rely on debt financing and, when they do issue stock, tend not to pay dividends. This Congress should not adopt a policy that so clearly benefits a small class of companies at the expense of so many others -- especially when, in general, these larger firms, frankly, are not providing the growth, jobs, and industrial creativity we need in this country.

This last point is illustrated by additional data from Compustat showing that the firms that paid dividends tend to have slower growth rates than those that did not. Over 42 percent of the dividends paid, $34 billion, came from companies whose average growth has been less than 5 percent over the last five years. In contrast, companies with the highest five year growth rates paid only $6.7 billion of the dividends in 1988.

Mr. Chairman, I am not an academician or tax lawyer. I manage companies. But these statistics should give you and this Committee great pause before you pursue these proposals. At the very least, they tell us: Be careful. This is not a zero sum game. Let's look very carefully before we take a step that will raise the cost of capital for the very companies leading America to economic renaissance. The Alliance would be happy to work with you and the staff to further develop this data to determine the distributional impact of some of the proposals you are considering.

Of course, in the end, all data is abstract. But my own experience as both chief executive and chief operating officer of major American growth companies deeply involved in industries facing tough international competition bears witness to the fact that limits on debt financing will starve dynamic, competitive companies of the capital they need to grow.

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We achieved most of this remarkable growth through leveraged acquisitions. Over the past five years, we bought the electrical equipment manufacturing divisions of several Fortune 500 companies, including the Magnetics Group of Litton Industries and the Universal Manufacturing Division of Farley/Northwest Industries, National Electric Coil from Cooper Industries, and Century Electric from Gould, Inc. In the process, MagneTek has become a national and world leader in the production of lighting ballasts, motors, generators, power supplies and other electrical products for both commercial and military use.

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MagneTek's debt to equity ratio today is nearly 10-1. We carry $410 million in debt and paid interest of $40 million in 1988. We paid only $3 million in dividends, all of it on preferred stock. Our shareholders understand that we are reinvesting virtually every dime of free capital to make the company grow. They do not expect short term returns.

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At the same time that we have improved Warnaco's operating efficiency, we have created over 1,500 new jobs in North America and the Caribbean Basin, bringing back production formerly performed in the Far East. And we have increased the capital expenditures and new products development budget for the company in each of the past three years. The company has $551 million in debt outstanding and pays interest of $72 million a year. It has paid $5 million in dividends, all on preferred stock.

You asked in your release for comments on how proposals to pare back the interest deduction would affect the ability of companies to compete. Let me put it simply and inelegantly:

You would stifle the progress of a company like MagneTek which, in just five years, has risen to challenge our foreign competitors. You would seriously inhibit the growth of a company like Warnaco, one of a handful of American textile manufacturers successfully competing with Asian producers.

Almost without exception, my foreign competitors have a cheaper cost of capital than I do. If you reduce the interest deduction, you will make it harder for me to keep up with them. Dividend relief at the expense of the interest deduction may produce some positive benefits for some companies. But I can tell you this for sure: it will certainly make it harder for my companies to keep pace with our foreign competitors. I hope that is a price you decide is too costly for this country to pay. Thank you.

APPENDIX A

COMMENTS ON SPECIFIC PROPOSALS

1. Re-classify certain debt as equity (B-3)

This idea is fundamentally flawed. It substitutes a political view for the reality of corporate finance.

In the real world, the difference between debt and equity holders is usually quite apparent. The debt holders (banks, for the most part) are concerned about one thing -- the "downside." All they want is the interest payment and the principal returned under the terms of the loan agreement. They don't care how well a company is doing or what fantastic opportunities management sees for its company.

The equity holders (pension funds, institutional investors, individual stockholders), on the other hand, are making an investment in the companies and management's view of the future. They succeed and are rewarded only if the companies do well. Bankers, on the other hand, are rewarded so long as the companies don't fail.

These two different mindsets produce two very competing demands on companies. They also make quite clear the difference between debt and equity.

If MagneTek or Warnaco issues equity, such as common stock, in the public markets, I do not have a legal obligation to declare dividends to our shareholders. Shareholders cannot force the board of directors of a company to declare a dividend. In the event we manage poorly, shareholders can not force a company into bankruptcy; their only recourse is to sell their stock. That, of course, is one reason they demand such a high return: in the event of a bankruptcy reorganization, they are not at the table and can only hope the other creditors leave some crumbs for them.

Debt, on the other hand, is an entirely different story. Debt imposes a legal obligation on a company to make regular interest payments on its borrowings. The failure of my company to make these payments in a timely fashion -- whether it is in cash or further debt -- gives a creditor the legal right to file suit to seize the assets of my company. Creditors can drive my companies into bankruptcy, and take them over.

In essence, when we dispense with what have been called the "bell and whistles" that accompany some common or preferred stock and corporate bonds, the test with regards to debt and equity comes down to this: if the holders of the securities have a legal claim on the assets of the corporation if it fails to pay interest and principal on a pre-determined schedule, they are holding debt. And no amount of jiggering with the tax law changes that. Payments with respect to such instruments are appropriately entitled to a deduction for purposes of measuring income.

2. Establish "normative" debt-to-equity ratios (B-7)

There is no such thing as a "normal" or preferable debt to equity ratio. The appropriate level of debt varies industry by industry and company by company, and is affected by a variety of other factors, such as cyclicality of interest rates and general economic conditions.

In addition, a firm's capital structure is forever changing, depending on its maturity and market conditions. At one point, a firm may have a very high debt-to-equity ratio; a year or two later, it may be lower. How would the tax code address this reality?

Over the past two decades, the debt-to-equity ratios of most American firms have risen substantially. Thus, an acceptable ratio in 1969 might not be "normal" today. Any effort to enshrine a normal level in law for tax purposes would have to take into account the fact that the definition of normal may change over a relatively short period of time.

3. Limit the interest deduction when debt carries "equity-like returns by disallowing the deduction for interest a fixed amount over the AFR (B-6)

In a typical leveraged transaction, equity holders demand returns that often amount to 2-3 times the prime rate. Thus, when prime is around 11.5, as it is today, equity holders look for an annual return of 25-30 percent or more. The subordinated debt in such a transaction will probably be in the 15-16 percent range. In other words, it may be a high rate, but it doesn't begin to approach "equity-like" returns.

Further, tying any limit to the AFR makes little sense since that rate has little relationship to the actual cost of borrowing. In order to approximate the borrowing rate paid by the most creditworthy corporate borrowers, you would have to add 1-2 percent to the AFR. Viewed in this light, capping the interest deduction at 3 or even 6 percent over AFR makes little sense since it amounts to capping the rate at just a few points over prime. Moreover, tying a cap to a single rate for all companies inevitably will favor the strong over the weak. Any proposal that seeks to limit interest deductions based on an absolute rule should be tied to each company's rate on its clear debt. Failure to focus on individual companies will disproportionately affect the very companies most in need of assistance.

The fact is that no emerging growth company can finance itself entirely with bank debt. So, once senior bank debt is in place, we must go elsewhere. Because we are not one of the 800 or so investment grade companies in America, the debtholders will demand a premium over prime of 2-4 percent, at least. Clearly, a cap at 3-6 percent over AFR may effectively deny the interest deduction for many of these emerging growth companies who depend on the subordinated debt markets to round out their corporate financing. Moreover, a high interest rate does not change the nature of the underlying investment -- it is still debt.

4. Limit the tax deductibility for pay-in-kind securities and zero coupon bonds (B-9)

Clearly, these bonds can be abused by enabling marginal, highly leveraged firms to take on new debt without truly having the present or future earning stream to support that debt. But like everything else, there is another side to the story.

There is an assumption in discussing PIKs, or deep discount bonds, that companies that issue them do not deserve to borrow. Clearly, these investments allow higher levels of borrowing -- but consider the case of a fast growing company that has reached its productive limits. To keep growing, it wants to build a new plant. But it lacks the current earnings to support cash interest payments on new debt. A PIK bond offers it a way to add the new capacity and defer the actual payment of cash interest until the new plant is contributing to revenues. Or, consider a company in an emerging industry. Unless it has excess cash from other lines of business, it must borrow against future earnings. PIKS offer a way to tap the emerging market and defer payments until the market matures. PIKs can also be a conservative approach to borrowing by allowing a company the safety of conserving cash in difficult years, perhaps avoiding bankruptcy during a recession.

I understand there may be a mismatch concern with PIKs. The reason, as you know, is the tax exemption provided to pension funds. It does not make sense to penalize the issuers of these legitimate securities by increasing their tax burden in order to pay for a tax exemption given to certain investors.

5. Adopt a de minimis test to limit the impact on small business

This has a certain appeal. But it also is flawed. In industry after industry -- chemicals, packaging, steel, even the service industries -- the surviving companies must be the lowest cost producers and most efficient players. In some cases, this means that companies will have to grow to compete with foreign conglomerates. Establishing a de minimis test for the interest deduction imposes a penalty on this growth. It says that you will not only pay more in taxes, but you will also have a higher cost of capital as you grow to keep pace with your competitors in Japan, Western Europe, and elsewhere.

Moreover, whatever level is picked is, by its nature, arbitrary. How do you select the level at which a company would be exempted from new tax rules? What is a small company? What is a small amount of interest payments? Why is a $50 million company more worthy of special consideration in the tax code than a $200 million company or a $500 million company? Why should we encourage some highly leveraged $50 million company to take on more debt while discouraging a more prudently leveraged, but larger company from doing the same?

Mr. RUSSO. Let me just ask you this. Would you support some kind of an exemption for companies, say, under $850 million or $750 million in sales in terms of how we would deal with the interest deduction problem?

Mr. GALEF. I don't know how you distinguish between small companies and large companies. I don't know how you ever draw a line.

Mr. RUSSO. Well, you could do it by net sales. In your own statistics you talk about companies over $1 billion versus a company under $1 billion. It seems to me that if your statistics are accurate, the smaller companies reinvest more in their company and make it grow and create more jobs than do the larger companies which pay dividends that don't create more jobs and don't expand the size of the company.

Mr. GALEF. Yes, sir. But, if you take—take a look at MagneTek and MagneTek's history. MagneTek, we began it by purchasing the Magnetics Group of Litton Industries, which was doing $190 million and breaking even, and we did it with high yield debt and some preferred stock. We continued to borrow money to grow. At what point would you cut it off? Today we are at $900 million in sales and we are now starting to compete in the international markets on a very effective basis. So where between the $200 million and the $900 million would you cut it off? And where do you cut it off since we assume that in the next year with further use of debt we are going to be able to expand even more and get up to $1½ or $2 billion in sales?

I don't know how you ever draw the line as to when a company is——

Mr. RUSSO. I am not saying that is a perfect place to draw the line. All I am saying is, I am trying to respond to the concern that you raise. That 556 companies would get 86 percent of the dividend deduction versus the 5,500 companies who would only get the 14 percent. I am just trying to even out the playing field.

If my choice is try to even the playing field as best I can without hurting those midsized companies who want to grow and get the interest deduction, maybe I would just want to buy into your argument that we ought not hurt all these midsize companies. I am just trying to get your feel for it because you are representing midsize companies who use debt to expand.

Mr. GALEF. Well, obviously, the interest deduction is extremely important, and what I said back in the beginning was that if you want to create more equality by giving some equity relief, I think that would be fine. In terms of dividend relief, my company still would not be in a position to use that effectively because we reinvest just about every penny into the future growth of the company.

Mr. RUSSO. Mr. Carter, just one question. You told us in your statement don't use the tax laws to achieve this result. How would you suggest we do it then?

Mr. CARTER. Well, it depends upon what the specific concern is. But, if the concern is the ability of management, not to be able to change management, or let's talk about the hostile takeover situation. A hostile takeover means a takeover that is hostile to the entrenched management. That is what we are talking about. We are not talking about hostile to shareholders.

Mr. Russo. Well, I think what we are talking about is the companies in this country leveraging themselves up and with so much debt they could create a real serious problem for the economy should we ever have a downturn. The reason they turn to debt is because it is a tax benefit for them to do that. Now that is the problem.

Mr. Carter. Absolutely. Now, if a limit is to be imposed upon the debt equity ratio of a company, you already have a law on the books that has largely been unworkable for many years that would use the tax law to do that. If it has to be done, it ought to be done through the securities laws or through some other set of regulatory laws that deals with that specific problem. Because as soon as you start trying to do this with the tax laws, then you open the door for all sorts of financial maneuvering to try to get around the whole tribe of tax——

Mr. Russo. I am not an expert on securities law. How would the securities law work?

Mr. Carter. If you are talking about trying to establish a corporate democracy or some controlled system, and I am not a securities law expert. I don't know exactly——

Mr. Russo. I don't own companies. That is why I have to rely on you.

Mr. Carter. Yes. The point I am making is that if you want to establish a ratio within a corporation you could certainly have laws that deal specifically with the amount of debt that the corporation would legally be permitted to carry on its books.

Mr. Russo. But then that would prohibit a company like Mr. Galef represents. They have some very significantly—they have got a 10-to-1 debt-to-equity ratio which they need in order to make their small companies grow. Then are we in a position of favoring large companies who don't have that problem versus companies who want to grow.

Mr. Carter. Well, I am not saying that that is—my own view of the thing is that you don't need to do anything at the moment because I don't think the problem is as serious as it is being said. I haven't seen any great collapses that we are talking about, and we have seen a lot of LBO's take place in the last few years.

But, if it does become a problem and you are starting to see corporate collapses because of overstructuring of debt, then I recommend that the problem be addressed directly.

Mr. Russo. OK.

Mr. Carter. I don't know that that is the only answer, but that is certainly an answer and it gets away from this adding additional complexity to the tax laws that makes a lot of people sit around and think up ways around it and come up with new methods of using these, as they are termed, loopholes. Well, they are deliberately created loopholes.

Mr. Russo. Well, we tried to correct that in the 1986 act, at least on the House side. We did have a provision for paid up deductions.

Mr. Carter. Yes.

Mr. Russo. Unfortunately, it did not survive the conference. It would have balanced conditions a little bit. To do it now would make us put a tremendous amount of strain on the budget, even though this may not seem to be a zero sum game, in the world I live in, Mr. Galef, it is a zero sum game. I am not allowed to do anything over here that creates a tax loss unless I can pay for it. Now that may not be the right way to do it, but that is the way we live when you have a budget deficit that really is about $270 billion, not the $140 billion that they say it is.

Mr. **Carter**. Well, the fact is that if the proposal to limit the LBO debt is successful, then you have lost all of the revenue because you have cut out the excessive high interest rate debt. So there is no revenue to it if it works. And if it doesn't work, why do it.

Mr. **Galef**. Mr. Russo, I should also tell you that neither myself nor my company is opposed to raising taxes.

Mr. **Russo**. Thank you. I appreciate it. I will remember that when I have to cast my vote. Unfortunately, some of your 13,000 people don't live in my district. That is a part of my problem.

Well, I appreciate the testimony and thank you very much.

Our next panel is a panel of five members: Mr. Louis Kelso, from Kelso Institute for the Study of Economic Systems; from Benefit Capital Companies, Inc., in Inglewood, CA, Mr. Wayne G. English, and he is going to be accompanied by a few people, by Mr. Alan Prosswimmer; from Benefit Concepts New York, Inc., New York, Daniel E. Carpenter, accompanied by Mr. Israel; Employee Stock Ownership Association, Steven Koch, treasurer; and John Menke, of Menke & Associates, from the great city of San Francisco.

Mr. **Russo**. Let me just ask the gentlemen—there are five of you here. I don't know when we are going to vote again, and as you can see, if I take off it ends the hearing until I return.

I would appreciate it if each participant would limit themselves to 5 minutes, because all of the testimony will be made part of the record and we may be able to achieve this result before another vote occurs on the floor of the House.

So the first witness who will testify will be Mr. Louis Kelso.

Mr. Kelso.

STATEMENT OF LOUIS O. KELSO, PRESIDENT, KELSO INSTITUTE FOR THE STUDY OF ECONOMIC SYSTEMS, SAN FRANCISCO, CA

Mr. **Kelso**. Thank you, Mr. Chairman. I appreciate very much being invited to be here. My appearance is for the Kelso Institute for Study of Economic Systems, a research foundation which we organized some 30 years ago. I am also chairman of the board of Kelso & Co., an investment banking firm that uses employee stock ownerships plans in financing.

To the best of my knowledge, I invented the LBO and I also invented the ESOP. The first LBO was the first ESOP. That was somewhere in 1955–56. Long before then, after years of study, I had concluded that the idea of work upon which our economic policy is built had been radically changed over the 200 years since Adam Smith laid down the principles of market economics.

To apply market economics today, in an industrial economy I believe that a labor worker needs to become—a labor worker man needs to become capital equipped labor worker man. In other words, the concept of work has been changed from labor intensive to capital intensive, in that direction, and for all the talk of leveling the playing field that doesn't solve the overall problem of Congress, and particularly of this committee. You need to make certain that the players on that field are equally armed, and I say that for citizens to earn a good living as I read the Constitution to say that is obligation No. 1 of Congress, of the government to people, to create an environment where they can earn a good living. They all need to be equipped with capital ownership because the real history of the industrial revolution is a change from 1776, when labor provided 95 percent of the value of the input, to today where I estimate, if we were not rigging the price of labor and hadn't been doing it for 50 years, labor would provide less than 10 percent of the input and capital 90.

When I first analyzed that problem on its face you would say that it couldn't be done. We live in a society where everything is owned, where all producer goods are owned, and where the Constitution rigidly protects private property. I think the ESOP does that, meets every possible test of protection of private property, and it does broaden ownership.

It makes capital credit accessible to people other than those who historically had access to capital credit; namely, historically it was the well capitalized. That is why the rich constantly get richer and the noncapital owners failed to acquire capital ownership over the centuries.

The theory is that if you work hard and save you will accumulate a competence of capital holding. Five percent of the American people own all the nonresidential capital in the United States today. They owned it in 1776. It was then land. It is largely fabricated capital today. The reason is that capital credit was made accessible to the already rich.

The ESOP made it available to employees. In the red booklet which I filed with the committee in support of my testimony, you will find a substantial discussion of the other seven techniques. It is perfectly clear that only about 25 percent of the American people derive their incomes from successful corporations that can be affected by the ESOP. The other seven techniques, however, make it possible to build capital ownership into all people who want to earn a good living in the industrial world.

Many times in these hearings today the question has been raised, how can we lower taxes? How can we lower the budget deficit? How can we do that and solve the problems we are up against? The answer is quite simple. The whole history of taxation over the last—well, since 1932—makes it perfectly clear that most taxes are levied to redistribute income from the economically overpowered to the economically underpowered. Half of the taxes go to support welfare.

I estimate that somewhere between 10 and 15 percent go to support boondoggle; that is to say, jobs created to satisfy an economic policy that is 200 years out of date. A policy that says the only way to earn income is through your labor, when in fact the best way is through capital.

I submit that in my written testimony many of the unanswered questions that have been asked by members of the committee this morning and in the previous hearings are answered.

Thank you very much.

[The statement of Mr. Kelso follows:]

HEARING BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
ONE HUNDRED FIRST CONGRESS — FIRST SESSION

WASHINGTON, D.C.

TAX POLICY ASPECTS OF MERGERS, ACQUISITIONS, LEVERAGED BUYOUTS AND RECENT INCREASES IN CORPORATE DEBT

Testimony by Louis O. Kelso on the Fairness, Tax and Economic Policy Implications, Practical Feasibility and Administratability of Legislative Options Reviewed in Press Release #13 of the Committee On Ways & Means Dated April 12, 1989

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MAY 17, 1989

THE PROPONENTS

Louis Kelso is an economist, author, lawyer and investment banker, and is President of the Kelso Institute for the Study of Economic Systems ("Kelso Institute"). The research activities of the Kelso Institute have focused upon reconciling the demonstrable impact of the Industrial Revolution with the principles of classical free markets economics formulated by Adam Smith and others before the Industrial Revolution.

Louis Kelso's studies of economic policies and the structure of economic systems led him to conclude that classical private property, free market economic theory first analysed by Adam Smith is fundamentally sound and is a reliable guideline for the structuring and operating of a modern industrial economy, providing its basic factual assumptions are updated to conform to the industrial facts of life.

Specifically, this means that to apply the logic of private property, free market economics to a modern economy, means must be institutionally provided to enable all people to equip themselves with privately-owned capital to supplement their privately-owned labor power. Kelso has developed the financing techniques for accomplishing this structural reform in the American economy. The best known of his eight basic reform strategies, each of which uses the same financing logic, is the Employee Stock Ownership Plan (ESOP) towards the perfection of which Congress, between 1973 and 1989 has enacted some 20 laws.

The Kelso Institute is a non-profit education and research foundation organized by Louis and Patricia Kelso in 1966 for the purpose of engaging in research into the adequacy of economic systems to serve the goals of post-industrial free democratic societies. Patricia Kelso is a Vice President and director of the Institute and assisted Mr. Kelso in the preparation of this memorandum.

THE COMMITTEE'S HEARINGS DO NOT ADDRESS THE CAUSE OF THE NATION'S BUDGET DEFICITS

The thesis of this testimony and memorandum is that these hearings by the Ways & Means Committee, seeking ways to cope with the nation's budgetary deficit, are in their entirety addressed merely to the ***effects*** of the budget deficit and ***do not focus on its cause.***

THE CAUSE OF THE NATION'S BUDGETARY DEFICIT LIES IN THE FACT THAT CONGRESS DECEIVES AND CONFUSES THE AMERICAN PEOPLE BY MAINTAINING IN FORCE AN ERRONEOUS AND MISLEADING NATIONAL ECONOMIC POLICY.

That policy, embodied in the Employment Act of 1946 (15 U.S.C. 1021), proclaims in effect that all of the income-earning and income-distribution problems of the population can be solved through their employment as workers, and implicitly proclaims that it makes no difference who owns the nation's productive capital, as long as funding for capital transactions is available and adequate.

Some of the Economic Consequences of the Absolutely and Factually Erroneous National Economic Policy

Here are some of the principal consequences of maintaining and operating the economy on the basis of a national economic policy that misrepresents the truth about how goods and services are produced, and thus how our citizens do, can and should earn personal income.

- Rising federal deficits and rising permanent federal debt;
- Larger, and increasingly unrepayable, foreign indebtedness to the U.S. and U.S. banks;
- Rising federal and state taxes;
- Rising trade deficits;
- The decline of the United States as the world's economic leader;
- The debasement of U.S. craftsmanship;
- The spiraling concentration of personal capital ownership by the plutocratic minority;
- The absence of nonresidential personal capital ownership by the 95% majority;
- Adversarial strife between management and labor;
- Rising alienation throughout the country, leading to narcotic use, terrorism, arson and general violence;
- American working people and the poor become increasingly victims of technological progress and conventional capital finance.
- Labor unemployment, including unemployment concealed by boondoggle, which, we estimate, accounts for perhaps 20% of the presently "employed" labor force;
- The decline in the quality of economic life in the United States during the last decade;

- The growth of an economic underclass within the nation— people who simply cannot earn enough to live a decent economic life;
- Our inability to raise the earning power of those who would purchase far greater quantities of goods and services and enjoy higher and more secure standards of living if they only could but afford to do so, thus creating the powerful consumer markets that powerful producers want and need;
- Our diminishing status as a world creditor nation and our retreat to the status of a debtor nation;
- The fact that our society is becoming increasingly uninsurable — proof that economic progress is slowing dangerously.

The Problem

Our national economic policy — the foundation of our business and labor policy — is the Employment Act of 1946. This policy law asserts — in effect — that the American people can, through jobs alone, achieve their goal of earning a good living. Unofficially, this has been our national economic policy since the founding of the nation in 1776.

But during the succeeding two centuries, the Industrial Revolution has been slowly but relentlessly accelerating.

And what is the nature of that technological revolution? It is an ongoing revolution affecting every aspect of every area of production — manufacturing, mining, agriculture, services — *a revolution that has changed — and is changing — the nature and meaning of work.* Changing it from something that people once did exclusively through their labor power to something people do today through their labor input and through capital (land, structures, machines and capital intangibles, normally represented in the U.S. economy by capital stock).

But while each individual is vested with ownership of his or her labor power as individual *private property*, today's production is carried on, with rare exceptions, by people who work with their own labor power and *with other people's capital.* Ninety-five percent of all nonresidential capital in the U.S. economy is owned by the top five percent of wealthholders. Nature's preindustrial economic policy of democratic individual ownership of economic power based on labor has not been extended to economic power based on capital. In Colonial times, labor did provide at least 95% of the value of input into production of goods and services. It was upon this that Adam Smith based his fundamental assumption that the only way people could participate in production and earn income was through their labor power. But this logic does not apply to an economy that has undergone the change made by two centuries of the Industrial Revolution. Today, we estimate, 90% of the gross national product, if the price of labor had not deliberately infalted over the past half-century, is produced by people who work through their capital.

All of the conventional techniques of capital finance in our economy — except those developed by Louis Kelso to implement his theory of binary economics, including the ESOP and seven other methods not yet legislatively implemented — make capital credit, indispensable to effective capital acquisition, accessible only to individuals who are already well-capitalized, and deny it to the 95% majority who own no capital assets except their homes. **Thus a defective national economic policy does not make it a primary goal of the economy to so use its institutions to enable people, beginning early in their adult lives, to equip themselves with capital ownership to supplement the earning power of their labor!** The result is an economy that constantly makes the overproductive rich ever richer, and fails to make the underproductive majority more productive through capital ownership; by making them *capital workers* as well as labor workers!

Since 1932, we have been living on various kinds of redistribution of income from the minority with higher earning power to the majority with lower or no earning power. At least 60% of all taxes collected today by the state and federal governments is used to support transfer payments and boondoggle in order to carry out this redistribution.

> ***In other words, 60% of state and federal taxes collected each year represents the cost of Congress' factually-flawed national economic policy.***

The relentless forward movement of technological change, combined with this anachronistic economic policy, forces us to constantly increase coercive redistribution.

The Solution

The National Economic Policy of the United States needs to be corrected so that it recognizes *not* just the goal of full employment, but the goal of enabling *every worker*, and in due course *every person and family*, to become an owner of sufficient productive capital to bulwark his or her or their lifetime earning power.

There are several thousand ESOPs in operation today in American corporations. Most are building solid ownership of significant capital into working people while simultaneously financing the growth of the firms for which they work.

- This technology enables employees to buy capital and to pay for it out of the pre-tax earnings of the capital they have purchased, normally within four to seven years.

- Correcting our national economic goal would stimulate the legislative implementation of the seven as yet unused binary methods of finance, each of which employs the logic of the successfully tested ESOP, in order to expedite the movement to make capital owners (capital workers) out of all Americans, and to eliminate the bulk of state and federal taxes required to provide supplements to their labor earnings or welfare payments.

The Specific Recommendation

One method of implementing this recommendation — to shift the economic policy of the United States from a mere full employment policy to a binary economic policy, calling both for full employment and for universal capital ownership for Americans — is set forth in Exhibit A hereto. This is comprised of pages 122 and 123 from our book, *Democracy and Economic Power: Extending the ESOP Revolution.**

Nature's Economic Plan

Nature equipped man with innate economic power: the power to produce goods and services. With each stomach to be fed and body to be clothed and cared for, Nature added on arms, legs, eyes, ears, brains, muscles, etc. Each consumer was fitted out as a producer.

Nature relied upon two basic concepts — private property and democracy — in setting up this arrangement: each individual's labor power was established as his or her *private property*, and the allocation of economic power among people was *democratic*: one person, one labor power.

Nature's economic plan for the human race foreordained Adam Smith's development of free market economic theory, as well as the American Revolution, which our founding fathers led in order to gain the democratization of political power (the other half of social power, upon whose democratization Democracy itself rests).

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* Louis and Patricia Kelso, Ballinger, New York, 1986.

Smith saw that in a free-market economy:

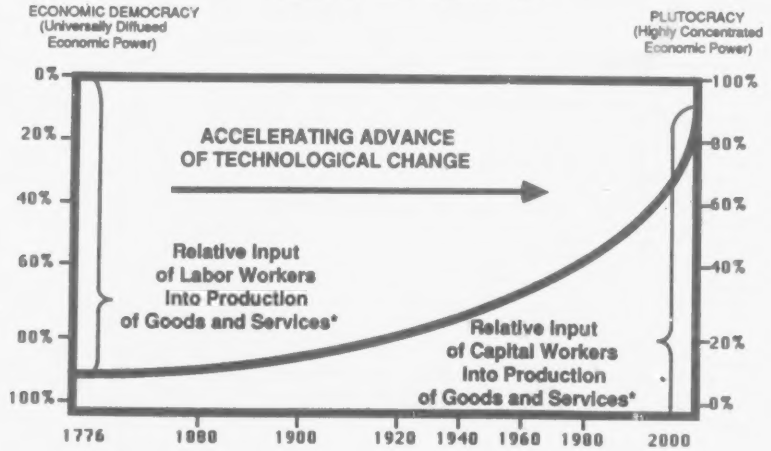
- There is no way to earn income except to participate in the production of goods and services under competitive conditions.
- Every person wants to live, so each will work to earn a livelihood. (The founding fathers believed the right to life, which implies the right to *earn* a living, to be an unalienable human right.)
- Since everyone wants to live better from year to year, and provide more abundantly for dependents, he or she will strive to work harder and more efficiently.

The motivational connection between producing goods and services and receiving income, relied upon both by Nature and by Adam Smith, was perfect.

A New and More Powerful Source of Economic Power Enters the Picture: The Industrial Revolution

Human beings, creative in their own right, became dissatisfied with unremitting toil to provide an animal subsistence. They began to make tools and implements to lessen personal toil and improve output to raise their standard of living. In time, technological innovation was advanced to the point of decoding Nature's laws and harnessing Nature's powers in capital instruments and processes so as to make them work for their owners; to take over progressively more of the burdens of production. This technological revolt against poverty and toil was well underway in England by 1776, and in the United States within four decades thereafter.

CHANGING PARTICIPATION of LABOR WORKERS and CAPITAL WORKERS in PRODUCTION of GOODS and SERVICES



*Estimated on the assumption that the value of productive inputs is measured in reasonably competitive markets.

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But modern man seems never to have understood what the Industrial Revolution was in essence: a revolutionary change in the *nature and idea of work.* As a result, he failed to correlate this radical change with nature's original economic plan for the human race. Had he done so, and at the same time factored in, as did Adam Smith, the logic of private property, free market economics (which recognizes the dual nature of man as a producer and consumer and that a strong market economy is equally dependent upon powerful consumers and powerful producers), man would necessarily have developed institutions which assured that as the Industrial Revolution advanced, the acquisition of capital earning power to supplement their labor earning power would be possible for all individuals and families. *Individual capital ownership would have become universal.*

Had philosophers, statesmen and other leaders perceived, early in the industrial era, what was being changed, they would certainly have realized that in an advanced industrial age, only the state itself (the national government in each economy) can function as Surrogate for Nature to enable individuals democratically and legitimately to equip themselves with capital productive power to supplement, or in some cases supplant, the economic power originally provided to each individual by Nature.

Where Did Economics Go Wrong?

It erred at the outset, when Adam Smith in his *Wealth of Nations* assumed that labor would always be man's only source of economic power. But the mistake was buried in the desperate efforts of a rapidly expanding population to support itself and to cope with the chain-reaction explosive discoveries of the Industrial Revolution. Binary economics — the idea that man can engage in production both through his privately-owned labor power and through his privately-owned capital — was a fact of life from the beginning, even when there was only man and the earth, and the only form of capital was land.

For it is a basic fact that man was designed by Nature to participate in production as an individual; not merely as a cog in a collective. He is so structured that he must be individually equipped with social power in order to cope with his competitive fellow men; to be treated as an equal in a society where economic power rests not merely upon labor power, but upon *labor power fortified with capital ownership.* This called for the democratic distribution of social power among people, and Nature took the first step, pointing the way to Democracy in general, by democratically allocating the primary power needed by man — *economic power*, the power to produce goods and services. The division of labor demonstrates that any number of persons can join together to accomplish complex tasks and indeed perform the tasks more efficiently. This was one of the first advances in the factory system. But even in great enterprises, people are individually hired and are individually accountable for their performance. It is their individually-owned powers that establish their societal and economic status and their human dignity.

In the U.S., the Declaration of Independence, the Constitution, the Common Law of Private Property and the Logic of Free Market Economics All Argue for a Binary National Economic Policy — Not a Mere Full Employment Economic Policy

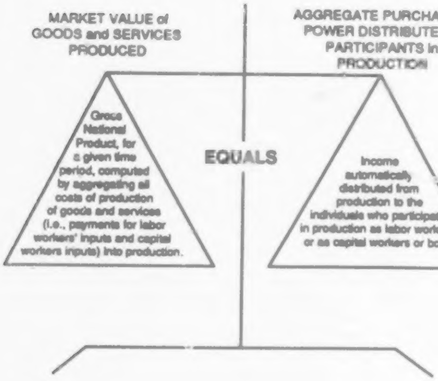
The rights of each citizen to life, liberty, and the pursuit of (economic) happiness cannot be fulfilled without recognition that the first duty of the Federal Government towards each citizen is to provide an institutional infrastructure that will enable him or her to equip himself or herself to earn a good living *in an age when most goods and services are produced through capital.*

- The right of each citizen to governmental protection of his or her privately-owned economic power against impairment of its value by the onward march of governmentally-sponsored and encouraged technological advance, can only be effected by extending to the individuals so injured due process in the form of access to capital credit to enable him or her to restore and expand their earning power through equipping themselves with adequate capital ownership.

- The right of each citizen to equal protection of the laws is flagrantly denied by laws and by business and financial practices that make capital credit available to the well-capitalized, and deny it to the uncapitalized, thus establishing an economy that continuously increases the capital ownership of the rich and denies such ownership to the 95% of the population who own no nonresidential capital.

- The common law of private property, which forbids an owner to use his capital in such way as to injure the person or property of another, or in ways that injure the public welfare, is scoffed at by those who hoard the ownership of more productive capital than they use, or want to use, or can use, to provide income for the support of themselves and their dependents. Yet the sole legitimate purpose of production is to support the consumption of the producers. To hoard the ownership of productive power that the owners cannot and do not use to support themselves and their dependents is to deprive others of the opportunity to earn enough income to support their own proper lifestyles. This is the logic of a free market economy, as the following diagram demonstrates:

ADAM SMITH'S "INVISIBLE HAND":
THE LOGIC OF A FREE-MARKET ECONOMY


MARKET VALUE of GOODS and SERVICES PRODUCED
AGGREGATE PURCHASING POWER DISTRIBUTED to PARTICIPANTS in PRODUCTION
Gross National Product, for a given time period, computed by aggregating all costs of production of goods and services (i.e., payments for labor workers' inputs and capital workers inputs) into production.
EQUALS
Income automatically distributed from production to the individuals who participate in production as labor workers or as capital workers or both.

Balancing the Federal Budget and Radically Reducing State and Federal Taxes Through Adopting and Implementing a Binary Economic Policy

Most taxes in every economy are levied to support income redistribution, either through welfare or through subsidized jobs to give artificial credibility to our erroneous national economic policy. All such schemes to reduce poverty by trying to offset its effects are paid for by consumers or taxpayers who live in or trade with these misguided economies. Since the United States has failed progressively to enable people to equip themselves with the ownership of capital, thus rendering them less and less able to support themselves, as the nature of production continues to change from labor-intensive to capital-intensive, any governmental effort to control or limit the continuous rise in redistributive taxes — like the Gramm-Rudman Bill or the tax or budgetary measures considered in these hearings — will curtail the standard of living of those who, without effective access to capital ownership, must rely upon progressively greater subsidization.

On the other hand, using the financial power of the economy to equip economically underpowered people with the ownership of productive capital both raises the productive power of the economy (economic growth) and individual and family earning power. At the same time, it provides government a means of eliminating the great bulk of taxation by progressively reducing its need to finance welfare and subsidies.

Recommendations to Congress to Raise the Earning Power and Tax-Paying Power of the People, While Reducing the Need for Taxes

Since the New Deal made its error in interpreting the national economic policy a half-century ago, we have been struggling to increase the number of labor jobs in the belief that this would make Americans more prosperous and self-supporting. Now more than 60% of households have two labor worker income-earners. But for the majority, the economic quality of life is — inevitably — going down, not up. The rearing and education of children is neglected as never before. It now takes two or more paychecks to do what one did — and did better — a few decades ago.

Let's stop pretending that it makes sense to "create more jobs" for people who need more income and more time to pursue other goals of life than struggling to earn income by preindustrial means. Why do we proletarianize the lives of most American families? What our economy needs is about 150 million more capital workers. The technologically superseded idea of production, of work, as something people not equipped with adequate capital can do today leads only to strategic and fiscal disasters.

In 1988, aggregate capital transactions in the American economy exceeded $700 billion. No more than 3% or 4% of those were ESOP-financed to achieve both efficient capital financing and to democratize capital ownership for employees. To implement a national economic policy that recognizes Adam Smith's free market principles today, we must correct our national economic policy to a binary policy, and take steps that will equip working people, and in due course, all others, with capital to adequately supplement their labor power. If half of the capital financing transactions that took place in 1988 had been ESOP-financed, this could have put five million families on the road to becoming middle class labor/capital workers. If the policy were continued for ten years, half of America's families would be capital-equipped. The impact on economic growth, tax reduction, deficit-dissolving, and new job openings would be spectacular.

By belatedly correcting the error in our national economic policy, Congress could withdraw from its unseemly preoccupation with redistributing other people's money. It could instead administer a new rational and humane economic policy which calls for enabling all underpowered, capitalless consumers to equip themselves with enough capital productive power to earn good incomes without government-enforced redistribution of income from taxpayers and consumers. A New Economic Age would dawn. *Homo laborens* would become *homo fabricans.*[*]

But What About the Three-Fourths of the Population Who Do Not Earn Their Incomes Principally From Employment by Prosperous Corporations?

We estimate that only about 25% of Americans derive their incomes from jobs in prosperous corporations where ESOPs can raise their earning power significantly. But the problems of these non-corporate employees in earning good livings are just as great, if not greater. For an economic system to be acceptable and suitable to the people as a whole, it must give all those who live under the system the opportunity to *earn* a good living.

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[*] Labor worker man would become capital-equipped labor worker man.

There are millions of people who earn only marginal incomes in self-employment, or in small and precarious enterprises. There are the millions of marginal farmers, government employees, school teachers, artists, scholars, writers, innumerable varieties of professional workers, the sick and the infirm, and those too old to hold employment.

That is why we developed seven other financing techniques, each one employing the market-tested logic of the ESOP. These, used either individually or in parallel with one or more of the others, would enable people to equip themselves legitimately and efficiently with viable holdings of productive capital. Each of the eight methods, except the Residential Capital Ownership Plan (RECOP), employs the "simulfinancing" and "simulsaving" principle that makes the ESOP both a highly efficient technique of corporate finance and a uniquely powerful and efficient way for individuals to painlessly accumulate savings — by buying and paying for capital out of its own income.

Brief Descriptions of the Eight Binary Financing Tools Built on ESOP Logic, of Which Only the ESOP Has Its Stockholder Constituency Defined by Corporate Employment, All of Which Need Congressional Study and Implementation

ESOP: Employee Stock Ownership Plan. The ESOP is designed to build capital ownership into employees of a business in the course of efficiently financing its growth or other worthwhile corporate objectives, without touching employee paychecks or savings. For employees, the ESOP is that constitutionally-mandated missing link that gives them access to credit to buy the employer's capital stock and, without personal risk or liability, to pay for it from the pretax earnings of the assets underlying that stock. In other words, equalizing employees' access to capital credit with that of the already rich is a matter of according them their constitutional rights to equal protection of the laws.

MUCOP: Mutual Capital Ownership Plan. This financing method is intended to provide pooled ESOP financing for a number of corporations while building diversified portfolios of their stocks individually for their respective employees.

CSOP: Consumer Stock Ownership Plan. This technique is intended for use in public utilities, banks, insurance companies, and other businesses where long-term relationships between the producer and its customers are the rule. Through the intelligent use of credit, it builds capital ownership for customers while providing low-cost financing for growth of the corporation. The rate and extent of such growth is limited only by physical facts. It simultaneously raises the power of the consumers to pay for their purchases of goods and services while raising the power of the corporation to produce those goods and services. It would normally be used in conjunction with an ESOP for its employees.

GSOP: General Stock Ownership Plan. Designed to build capital ownership into politically-designated classes of consumers within the jurisdiction of the authorizing government — state, local or federal. While it is in need of several amendments, the text of a GSOP law was enacted by Congress in 1978. It was never actually used because it required counterpart state legislation, which was not forthcoming. The federal law has now expired by its own terms.

ICOP: Individual Capital Ownership Plan. A financing device intended to create viable capital estates for Congressionally-selected categories of individuals while opening broad markets for equity financings by corporations. This is potentially a more powerful tool than the ESOP. It would require broad use through the investment banking and banking systems, and could provide Congress with a means of stimulating economic growth and eradicating poverty on an unprecedented scale.

RECOP: Residential Capital Ownership Plan. This financing plan, in combination with commercially-insured capital credit financing, would enable homebuyers to purchase homes at less than 25% of the out-of-pocket principal and interest cost of similar transactions today, by having their acquisitions treated by tax and other relevant laws as capital assets, which they are, rather than as consumer items, as at present.

COMCOP: Commercial Capital Ownership Plan. Ownership of rental structures, such as office and apartment buildings, factories, mines, railroads, hotels, resorts, etc., are today a major source of capital-generated cash income. Today such structures and rental real estate assets generally are owned by the excessively wealthy (whose resulting income is thereby largely sterilized for purposes of the consumer economy, and denied to those who could use it if the financing had been COMCOP-structured). Such acquisitions today are used not only to satisfy antisocial greed, but to wipe out income taxes. COMCOP financing would enable commercial structure ownership legitimately to be spread over large numbers of people, raising their power to earn the incomes they need to make them powerful and self-supporting consumers, maintain their lifestyles, restore their confidence in democratic institutions, and to diversify their holdings in businesses in which they become employed as capital workers.

PUBCOP: Public Capital Ownership Plan. This plan is designed to provide low-cost financing for capital instruments used by public bodies of all types — office buildings, streets and sidewalks, parks, street lighting, schools, universities, subways, waterworks, harbors, etc. It permits broad individual stock ownership, through facilities corporations, by great numbers of people, while providing low-cost capital facilities to be leased at market rates to the cities and other municipal user corporations, the states, the federal government, and other public bodies that use or occupy such assets. PUBCOP financing is another tool in the arsenal of democratic capitalism to assure that each individual and family can become employed as a capital worker and that — as a matter of maintaining democratized social power (political and economic power) — governments do not acquire economic power that should be diffused throughout the citizenry. PUBCOP financing would employ the dual functions of other binary financing devices. That is, it would provide efficient and low-cost financing for public improvements and infrastructure, while generating private capital holdings for public employees and others selected by Congress as eligible stock buyers. It would be a major means of eliminating the cost of wasteful, inefficient, and inadequate public employee pensions, while providing much greater economic security and incomes, both before and after retirement, to public employees and others.

For fuller descriptions of each of these ESOP sibling financing tools, see Chapters 7 to 10 of *Democracy and Economic Power: Extending the ESOP Revolution,* Louis and Patricia Kelso, Ballinger, New York, 1986.

The Future of Binary Financing

Of the eight binary financing tools, only the ESOP has been partially legislatively implemented. The ESOP is the first pragmatic step into the New Age Economics that is mandated by the changes in the idea and nature of work resulting from the Industrial Revolution. Common sense, the precarious posture of the U.S. economy, and the threat to our democratic freedoms from totalitarian concentrations of economic power within the U.S. economy, tell us that it is time to implement the most powerful of the other seven methods: the ICOP, COMCOP, CSOP, PUBCOP and RECOP.

Exhibit A

A TEXT TO REFORM THE NATIONAL ECONOMIC POLICY LAW*

Unquestionably, a sound national economic policy is pivotal to sound corporate policy. Federal and state governments have the duty to adopt a sound economic policy. It is also government's duty to take primary responsibility for interpreting, administering, and enforcing the policy of redemocratizing economic power. Even though a few corporations, with significant help from Congress and some state legislatures, are beginning to use ESOPs, the dominant and accelerating trend within the U.S. economy today is still toward concentrating capital ownership into ever fewer hands. If we want to redemocratize economic power, we must do it through a new binary national economic policy.

Fortunately, the necessary policy legislation is already in place in the United States. Part of it will be found in the erroneously interpreted national economic policy law, which merely needs to be interpreted, applied, and enforced correctly. A key paragraph in Section 2 of the Employment Act of 1946 (15 U.S.C. 1021) refers to "employment" only in the conventional and traditional senses of the word. But that, of course, conflicts with the reality that an individual can participate in production and earn income not only by employing, or having others employ, his privately owned labor power, but also by employing, or having others employ, his privately owned capital.

Only about a dozen words in the act need to be changed or reinterpreted to correct this all-important policy declaration. Our suggestions are in bold type in the following paragraph that otherwise directly quotes the present law:

AMENDED DECLARATION OF POLICY

> *Section 2. The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture,* ***banking, finance,*** *labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment,* ***as labor workers and as capital workers, for all consumers desiring economic autonomy and self-sufficiency,*** *and to promote maximum* ***concurrent*** *employment* ***as labor workers and capital workers,*** *and maximum production and purchasing power.*

Work and *employment* are words that, rationally used, denote engaging in the production of goods and services and earning income as labor workers, as capital workers, or both. It is nonsense for us not to see that if there are two ways in which each individual can engage in production and earn income, then we must equally recognize as *work* both *labor work* and *capital work* that result in the production of useful and salable goods and services. And we must equally recognize as *employment* concurrent labor work and capital work, in any pragmatically sound combination.

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* Excerpt from *Democracy and Economic Power: Extending the ESOP Revolution*, by Louis O. Kelso and Patricia Hetter Kelso (Ballinger, Cambridge, 1986), pp. 122-123.

[THE ATTACHMENTS SUBMITTED WITH THIS STATEMENT ARE BEING RETAINED IN THE COMMITTEE FILES.]

Mr. Russo. Thank you very much, Mr. Kelso. I appreciate the fact that you were able to do that in 5 minutes, so thank you very much.

Our next witness is Wayne English.

Mr. English.

STATEMENT OF WAYNE G. ENGLISH, INDIVIDUAL GENERAL PARTNER, BENEFIT CAPITAL PARTNERS, L.P., WASHINGTON, DC, AND R. ALAN PROSSWIMMER, MANAGING DIRECTOR, BENEFIT CAPITAL, INC., DALLAS, TX, ON BEHALF OF BENEFIT CAPITAL COMPANIES INC.

Mr. English. Mr. Chairman, I am Wayne English. I am the individual general partner of Benefit Capital Partners, Limited Partnership, a firm which invests in companies where ESOP's are used as a technique of corporate finance. I retired from active participation in the business world some two years ago when I was chief financial officer of MCI Communications Corp. At MCI, I had been instrumental in installing an ESOP back in the 1979–80 timeframe. That ESOP today owns some 7 percent of the company stock, or something over $200 million.

Prior to coming with MCI, I had been with Hallmark Cards in Kansas City, MO. Hallmark has one of the largest ESOP's, which today owns approximately one-third of that privately owned and very successful company. I have been a great believer in ESOP's. I have seen them work. I have seen the benefits that have come about. I have been following Mr. Kelso's writings for many, many years. More years than I like to think about, Mr. Kelso. I would like to express my thoughts on a number of points that are up for consideration by this committee.

I believe very strongly that the interest exclusion for lenders under Internal Revenue Code section 133 which permits financial institutions to exclude from income 50 percent of the interest received with respect to loans to ESOP's or to employers making loans to ESOP's should be maintained at its current level.

No. 2, Code section 404—the deduction for dividends paid on employer securities held by an ESOP—should be maintained without change or limitation.

Point 3, present rules permitting an ESOP to be the only retirement plan of an employer should be maintained without change.

And point 4, a policy statement by this committee calling for a 10-year moratorium on any changes, adjustments, or revisions to all current ESOP laws should be adopted as a guiding principal for all members of the committee and for the entire Congress.

The interest exclusion to which I referred is the glue which holds this whole situation together and makes it possible to provide the employees the opportunity to acquire an ownership interest in the companies to which they render their services. This does not result in a long-term increase in debt, because that debt gets repaid through the medium of contributions made to the ESOP by the employer. It is a very convenient, a very efficient way of transferring ownership out of the closed loop which now exists to a group of people who have staked their lives on the success of this particular company, and it is our belief that that provision should be maintained without change.

We believe that the dividend deductibility is a vital tool in this whole process because it is a means of providing additional deductions for the company, particularly a company which is not a labor intensive company. The normal deduction is restricted to 25 percent of payroll. This provision permitting the use of dividends to repay loans was introduced into the code a number of years ago and has proved to be extremely valuable to those companies which are not particularly labor intensive.

With respect to the retirement plans, we have operated for years under a system of voluntary plans. We believe that it would be a real mistake to backtrack on that policy and insist that companies which have ESOP's also support another retirement plan. The economics would be extremely difficult for most companies to support a second plan. We regard it as totally unnecessary, and we believe that the present system works fine and should not be modified.

In short, we believe that the ESOP incentives are working. We need more active employer ownership, more active partnership by our employees if our economy is to become more competitive, and we sincerely hope that you will continue to support the opportunity employees now have to buy into the companies they work for.

Thank you for the opportunity to discuss this with you.

[The statement of Mr. English follows:]

Testimony before the
Committee on Ways And Means
Concerning
The Tax Policy Aspects of Mergers and Acquisitions
by
The Benefit Capital Companies Inc.
Wayne G. English, Individual General Partner Benefit Capital Partners, L.P.,
and
R. Alan Prosswimmer, Managing Director, Benefit Capital, Inc.

May 16 and 17, 1989

Introduction

My name is Wayne English and I am the Individual General Partner of Benefit Capital Partners L.P., an investment fund which invests in ESOP transactions. Benefit Capital Partners is a member of The Benefit Capital Companies Inc. The Benefit Capital Companies Inc. are a group of investor- and employee-owned companies working together to provide ESOP services nationwide. Our people are leaders in the design and implementation of ESOPs throughout the United States and have collectively been involved as a principal, consultant, or adviser to over 400 ESOP companies in the last decade. Our clients range from large public companies to small family-owned firms. Collectively, we have represented companies with total annual payrolls in excess of $2 billion and total annual sales exceeding $5 billion.

I have been a supporter of ESOPs for many years. I was formerly the Chief Financial Officer of MCI Communications Corporation here in Washington and as CFO was responsible for establishing MCI's ESOP, which today holds over $200 million of MCI common stock and has produced outstanding results for MCI. I am also a director of MCI and chairman of its finance committee. Prior to my tenure with MCI, I was a director of Hallmark Cards and its Chief Financial Officer. I was instrumental in converting Hallmark's profit sharing plan into an ESOP. Today Hallmark is the tenth largest employee-owned firm in America as measured by the size of firms that are at least 20 percent employee owned.

With me today is R. Alan Prosswimmer, a Managing Director of Benefit Capital, Inc., which is the investment banking member of The Benefit Capital Companies Inc. Mr. Prosswimmer was the Chief Financial Officer at Weirton Steel Corporation for four and one-half years. Weirton Steel is the nation's largest 100 percent employee-owned industrial corporation and a "Fortune 500" company. He was intimately involved in engineering Weirton's remarkable return to profitability. He is recognized nationally as a proponent of employee participation and job enhancement through employee ownership.

We are appearing today on behalf of The Benefit Capital Companies Inc.

It is our hope that the analysis we share with you today will lead you to conclude that this Committee should exercise its power and influence to encourage and expand employee ownership by permitting employees to vigorously and actively pursue ownership in their companies. Historically, the tax laws have provided advantages to buyers of businesses other than employees, and we should not step backwards in time or lose the momentum gained over the last several years in encouraging capital ownership by employees.

Advantages of Current Employee Ownership Tax Policy

Employee ownership works. It has been gathering momentum ever since Louis O. Kelso created the ESOP concept many years ago. In fact, research results show that companies with significant employee stock ownership programs have more highly motivated employees, higher profits, faster sales and employment growth, and a greater ability to weather recessions than companies which are otherwise comparable but have minimal or no employee ownership.[1] Employee ownership, especially when coupled with employee participation, leads to businesses being more productive. Weirton Steel is a fine example and Mr. Prosswimmer can provide Weirton's results if the Committee is interested.

If the current laws affecting ESOPs are left as they are, ESOPs will continue to be a viable alternative to the present dismemberment and wholesale slaughter of many corporations' natural shareholders (i.e. its stakeholder employees). Through a widespread sharing of both the risks and the rewards of a leveraged buyout, all of the employees whose efforts are essential to paying off the debt can be participants. Just as most employees acquire a home with leverage and work hard to pay off the mortgage, so, too, can they acquire capital for themselves and work hard to pay off the related debt. As with a non-ESOP LBO, ESOP financing utilizes the corporation's access to credit to finance the capital acquisition. For most ESOP companies, an ESOP acquisition has only one thing in common with an LBO: debt and leverage. But the similarity ends there. While an LBO makes owners out of a small group of managers and investors, an ESOP is almost the mirror image - it makes an owner out of practically everyone on the payroll.

An ESOP reorients a company by tightly linking the employees' retirement wealth to its stock performance. American industry must become more entrepreneurial. ESOP participants with an equity stake do work harder and, more importantly, smarter. (Please see Appendix I).

We urge the Committee and all members of the Congress not to lose sight of the importance of encouraging the use of financing techniques that expand capital ownership. To the degree that tax policy plays a part in acquisitions and mergers, that policy should operate to build capital ownership for a broad base of taxpayers. That is what ESOPs do.

Now is not the time to restrict and to curtail the only major way employees can use the only medium of exchange they have - their labor - to buy into the capital markets that are normally closed to them without a tax policy encouraging ESOPs. Encouraging employees to return to the capital markets as America's stakeholders can continue to create the environment in which shareholders (and the capital markets) look to the corporation as the long term provider of jobs and economic strength. We need high quality goods and services and production - not just financial speculation. Encouraging ESOP companies also enables tax policy to positively impact corporate performance and spark real economic growth by improving motivation, productivity, commitment, dignity, morale, competitiveness, quality, creativity and job place satisfaction, to name a few. Without the incentives already in place, Wall Street will once again be selling Main Street not to the employees but to largely absentee owners.

Continuing the carefully thought out tax policy already in place will help buffer companies against unwelcome takeovers, as ESOPs create stable, long-term shareholders - rather than instability and uncertainty as the roving global pools of takeover capital move from target to target.

ESOPs do not create more long-term debt in the long run. They give employees an opportunity to "equitize" that debt over time for their own benefit, not that of the predators. These hearings are an acknowledgment of the concern about the concentration of wealth through laws encouraging the use of debt rather than equity. ESOPs, in fact, reverse this very trend and, therefore, should not be discouraged by the undoing of carefully designed ESOP incentives. All of the tax incentives and other ESOP related laws fit together to provide an environment in which more and more people (taxpayers) can take advantage of and benefit from expanded capital ownership. In our view the total amount of ESOP financing is still far too small compared to the total financing in America. Others today, and in prior hearings, have provided strong statistical data to evidence that less than four percent of all the LBOs are ESOP related; however, please understand that ESOP financing, the use of an ESOP as a recognized technique of corporate finance, is in its infancy and we sincerely believe that this country should not commit infanticide by disturbing a carefully chosen and debated tax policy which has been working far better than anything else ever done to date to encourage employee ownership in America.

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[1] Employee Stock Ownership Plans: Business Planning, Implementation, Law and Taxation. Edited by Robert W. Smiley, Jr. and Ronald J. Gilbert. Prentice Hall Rosenfeld Launer. New York, 1989. See particularly Chapter 3. "Research Results," by Karen Young of The National Center for Employee Ownership.

In less than two weeks, over 100 senior members of various foreign delegations are coming to America to visit at The ESOP Association's 12th Annual Convention. The Soviet Union, China, Poland, Egypt, Costa Rica, Argentina, France, the United Kingdom, and Australia are among the major nations represented. While the rest of the world is aggressively pursuing ESOPs and implementing the sound concepts of employee ownership, this Committee is considering cutting back on and, in effect, crippling these concepts. This would leave the United States in the ironic position of watching the rest of the world benefit from implementing successfully our own invention, while we are abandoning it. There are substantial benefits to the nation to be derived from employee ownership.

Employees and the public also want ESOPs. Please see the "Survey Results" in Appendix II, attached.

The Interest Exclusion for Lenders

The interest exclusion for lenders is the "glue" that holds the transaction together. We believe that this has the lowest dollar tax loss of any of the ESOP benefits, yet is probably one of the most important for inducing lenders to provide financing for employees. Qualified lenders all over America are giving commitments of cash to employee buying groups to allow them to buy into corporate America. The interest exclusion is working well and resulting in substantially lower interest costs for ESOP loans because of the advantageous rates being offered in the marketplace. No longer are employees seen as the buyers of last choice or, worse, not as buyers at all. They have an opportunity to compete in the business auction process and to win - a far better alternative. For over 50 years employees were disadvantaged buyers under America's tax laws. Employees could only pay cash. They did not have stock to exchange when buying a business and so they could not compete with corporate buyers and Wall Street, but they can now, and they're winning.

Why take this momentum away in order to raise so little in revenue? The social costs of losing out on what ESOPs are doing for America are inevitably far more expensive, and a change in this lending provision would be short sighted at best because it would preclude these ESOP-owned companies from being the hefty taxpayers they have become.[2] This difference in tax treatment between the use of debt and equity should continue to exist for employees in order to continue to encourage employee ownership and all of its attendant benefits.

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[2] The United States Senate Committee on Finance conducted a survey of companies using ESOPs. The results provided Senator Russell B. Long with vital information to help him show Congress and the regulatory agencies that the promised success of ESOP companies was benefiting the economic welfare of the country. The survey results are attached as Appendix III.

Dividend Deductibility

Congress has already put severe limitations on the deductible limits for amounts that can be contributed by employee owners to buy into their companies. No more than 25 percent of eligible payroll may be contributed and deducted in any one year and used toward principal. Before the adoption of the deductible dividend provision, many employee groups did not have enough payroll to be able to attract the financing necessary to purchase the company and so lost out. Since 1984 the use of deductible dividends by ESOP companies has caused just what Congress wished to happen - to allow the credit of the corporation to provide the funds necessary to pay off the debt incurred to finance the transaction. This is much like the rent being able to pay off the interest on a mortgage on a warehouse building. After many hearings, the dividend deduction was decided upon. If the dividend deduction is going to be repealed or reduced, then a corresponding increase in the deduction limits is necessary. It is far more equitable to leave the dividend deduction intact, however, rather than to discriminate against employees who happen to work for more capital-intensive industries and do not have enough payroll to take advantage of the ESOP's inherent logic.

Supplemental Retirement Plan

Our current voluntary retirement plan system is well established, and we believe it would be a mistake to discriminate against ESOPs.

Currently, Congress does not require any employer to have a retirement plan, and no current proposals are being seriously considered. Our nation has a policy of voluntary retirement arrangements. Under the current proposal an employer wishing to establish an ESOP and allow employees to buy in also would be required to contribute to another "meaningful plan". Apart from the question of how to pay for this substantial extra expense, the issue of what employees actually get from an ESOP should be discussed. Employees are never liable for ESOP debt, and employees are rarely, if ever, liable for any additional non-ESOP debt and are therefore not "exposed" in the same sense as other buyers of companies. Although ESOP companies fail less often than non-ESOP companies,[3] in the event that a particular company should fail, employees are generally free to move on to another job without impaired personal credit risk. Employees are already given an ESOP diversification option beginning at age 55. These diversification rules, which are being complied with all over America, answered the "all eggs in one basket" concern. We do not understand how leveraging the ESOP could adversely affect the participants. To mandate an additional cost for the ESOP company puts a substantial additional burden on potential ESOP companies. We do not see in the proposals any suggestion requiring the buyer of businesses through merger and acquisition activity to put in a retirement plan; why discriminate against employee stock ownership plan companies?

If employees wish to stay with an employer, they are free to do so. The ESOP is an attractive benefit plan, and many companies are promoting their own ESOPs in their recruiting efforts, because ESOP participants traditionally have had larger account balances than other employees in similar firms with other kinds of plans. The National Center for Employee Ownership estimates that the average account balance of an employee owner in the typical ESOP will be substantially larger than the median assets of a family at age 65, which in 1983 were slightly less than $12,000. Employees will have in their ESOP accounts roughly twice their annual pay and, after 20 years, approximately six times their annual pay.

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[3] Arnold Tannenbaum, Harold Cooke and Joe Lohmann, "Research Report: The Relationship of Employee Ownership to the Technological Adaptiveness and Performance of Companies," unpublished (Ann Arbor: University of Michigan Survey Research Center, 1984). Arnold Tannenbaum and his colleagues at the University of Michigan completed a study of 115 firms and matched them to conventional companies. They then looked at how ownership affected profits, productivity and technological adaptiveness. They concluded, among other things, that ESOP companies were 10 percent less likely to go out of business during the 1976 to 1982 study period, half of which was a recession.

Congress is not considering requiring all LBOs to put in even one meaningful retirement plan, and we are not suggesting that; rather, we believe that employees should be given the same opportunity to compete on equal footing. Contributions to another plan also reduce the amount available to contribute to the ESOP because of the overall deduction limits of the Internal Revenue Code.

If the 404(k) dividend deduction, reduction or elimination of the lender interest exclusion, and the "other meaningful plan" requirements are adopted by this Committee, and become law, then it will make financing more difficult for employees to obtain. It's tough enough already to compete with other forms of corporate finance, even though employees are now finally being accepted as bona fide buyers, able and willing to pay the price necessary to win in the competing auction markets that virtually all successful businesses in America are now using to effect a change of control.

A "No Change" Agreement For ESOP Law

Stability in legislation is always desirable. We respectfully request this Committee give the future employee-owners of this country an opportunity to participate in the equity growth they can so directly contribute to by establishing a sound policy of "no changes to ESOP law", so that employees can continue to pursue at their option, the democratizing of capital that is just now reaching the proportions only hoped for a decade ago. We will be pleased to provide a draft of legislation that would accomplish this end. While it would be a "first", the underlying national policy would be a welcome change from the uncertainty constantly facing employees as well meaning but impractical changes to ESOP laws are contemplated or considered by this and other Committees of Congress.

Certainty under the ESOP laws will remove one of the greatest uncertainties employees face - the possibility that right in the middle of a transaction the rules are changed. This "moratorium" will make the plans tax efficient and companies will be able to accurately budget the costs of an ESOP and continue to forge ahead knowing that the law will remain constant.

This committee has heard, and we believe proof was given,[4] that ESOPs are involved in a very small number of corporate debt transactions. Raising federal revenues is, of course, an important part of running an efficient and effective government, but creating pools of taxpayers willing, able and ready to pay their taxes from corporate profits seems far more important for the long-run stability of the tax base than the virtually insignificant sums that could be raised by changing the current ESOP laws.

Conclusion

The ESOP incentives are working. The nation needs more active employee ownership and participation if it is to become more competitive. We sincerely hope that you will continue to endorse and support the opportunity employees now have to buy into the companies they work for. Thank you for the opportunity to discuss this with you. We entrust to you the power to protect the most dynamic, promising economic movement in the world today - employee ownership. We hope you will continue to encourage a key solution to the future of America.

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[4] Please see the March 15, 1989 "Testimony Before the Committee on Ways and Means Concerning Leveraged Buyouts," by Jeffrey R. Gates, consultant, and the Statement, February 2, 1989, by Richard D. Mendelson, President, Katz Communications, New York, on behalf of The ESOP Association.

Appendix I

STUDY RESULTS - ESOPs HELP GROWTH, PROFITS

1976	30 Companies	Profits UP 50%
1980	128 Companies	Productivity UP 1.5%
1982	43 Companies	Emplm't Growth 3X Industry Avg
1984	13 Companies	Sales, Margins, ROE, BV/Share IMPROVED
1984	364 Companies	Sales UP 33%
1984	156 Companies	Failure Rates 10% LESS
1985	28 Companies	Sales Growth UP 30% (ESOP 100% buyout)
1985	50 Companies	BETTER than U. S. Economy 1972-1981

BENEFIT CAPITAL

Appendix II

Survey Results

General

Most American adults believe that, compared with workers at non-employee-owned firms, workers at employee-owned companies work harder and pay more attention to the quality of their work, as an exclusive nationwide public opinion poll indicated.

In addition, more than half of all workers surveyed said they would trade their next wage increase for a share of ownership in their company.

The survey, conducted for this report by R. H. Bruskin Associates of New Brunswick, N.J., was based on 1,001 completed telephone interviews with adults contacted August 14-16, 1987, at their homes.

Four out of every five of those surveyed believe that workers at employee-owned companies pay more attention to quality than workers at non-employee-owned firms. Only 7 percent of the respondents disagreed. A similarly large majority - 81 percent - thought employee-owned company workers paid more attention to their firm's financial performance.

Sixty-nine percent thought workers at employee-owned firms worked harder than workers at non-employee-owned firms; 18 percent disagreed.

57% Would Trade Wage Hike for Stock

Fifty-seven percent of workers polled said they would be willing to trade their next wage increase for a share of company ownership. Willingness to make the trade appears to be related to income. Two-thirds of respondents earning more than $40,000 said they would make the trade, while just under 40 percent of those earning less than $20,000 would do so. Full-time workers also appear to be more inclined than part-time workers to make the wage-hike-for-stock trade. Fifty-nine percent of full-time workers said they would make exchange, while 44 percent of the part-timers said they would do so.

Personal earnings were one of the few factors that appeared to have a significant effect on respondents' answers. For example, 69 percent of those who earn under $15,000 thought employee-owners are more quality conscious, compared with more than 80 percent of those who earn more than $15,000. Otherwise, responses to each of the questions did not vary significantly by sex, race, age, educational level, or region.

Interestingly, this lack of variation held true for respondents who said they worked for employee owned companies. On all questions they voiced opinions nearly identical with those of respondents who said they did not work for employee-owned companies. An unusually large percentage of the respondents - 19 percent of the 617 employed persons polled - said they currently work for employee-owned companies. The actual percentage of American workers working for employee-owned companies is under 10 percent, according to the National Center for Employee Ownership.

Employee Ownership Helps Sales

The poll indicates that the by overwhelming margins, Americans believe workers at employee-owned firms work harder and pay more attention to quality. But how might this affect peoples' purchasing decisions? The poll attempted to find out by asking which of two apparently similar products people would buy: one made by an employee-owned company, or one made by a non-employee-owned company.

Just over half - 51 percent of respondents - said company ownership wouldn't make any difference in their purchasing decision. But 41 percent said they would choose the employee-owned firm's product; only 3 percent said they would choose the non-employee-owned company's product.

Income appears to be related to this preference. About 46 percent of respondents earning $30,000 or less said they would choose the employee-owned company's product, while 33 percent of those earning $40,000 or more said they would do so.

NOTE: The survey results were published in Employee Ownership Plans: How 8,000 Companies and 8,000,000 Employees Invest in their Futures, A BNA Special Report published in 1987. Copies are available from the Bureau of National Affairs, Inc., Customer Service Center, 9453 Key West Avenue, Rockville, MD, 20850. Ask for BSP73.

Appendix III

Survey of ESOP Averages Shows Benefits to National Economy

The United States Senate Committee on Finance did a survey of companies using ESOPs. More than 80 companies responded, with statistical results gained from 72 that gave complete information. The results provided Senator Russell B. Long, then chairman of the Senate Finance Committee, with vital information to help him show Congress and the regulatory agencies that the pronounced success of ESOP companies was benefiting the economic welfare of the country.

The following averages emerged from this important study:

- At the time of the ESOP installation, which took place three years prior to the study, the typical company had been in business for 24 years.
- Over the prior three years, an average of 7% of the ownership of the company was transferred each year, until the employee stock ownership plan had 20.6% of the company stock.
- During those three years, from the pre-ESOP to post-ESOP, annual sales increased from $19,596,000 to $33,780,000, a 72% rise.
- The number of employees grew from 438 to 602, representing an employment jump of 37%.
- The incentive provided by employee stock ownership may have had an effect in significantly raising the productivity from $44,700 sales per employee to $56,000 - an increase of 25%.
- The annual profit generated before the ESOP was $794,000 and soared post-ESOP to $2,039,000, an increase of 157%.
- The company paid taxes, prior to the ESOP, that averaged $312,000 per year. Post-ESOP, that typical ESOP company paid an average $780,000, an increase in revenue to the government of 150%.

The sampling of companies was limited.

Mr. Russo. Thank you very much, Mr. English.
Mr. Daniel Carpenter.

STATEMENT OF DANIEL E. CARPENTER, PRINCIPAL, BENEFIT CONCEPTS NEW YORK, INC., NEW YORK, NY, ACCOMPANIED BY DONALD M. ISRAEL, PRINCIPAL

Mr. Carpenter. Thank you, Mr. Chairman. I will be speaking on behalf of myself and my partner, Don Israel. We are with Benefit Concepts New York, Inc. Our firm does the design, installation, and administration of all types of benefit plans, but mostly ESOP's. We are here today to speak on behalf of the many thousands of small business owners who have adopted Employee Stock Ownership Plans or will adopt them in the coming years.

It was once said that what is good for General Motors is good for America. Well, now that small business is the big business of America, almost the opposite is true. The excitement these days is in the INC. 500 and not in the Fortune 500 type of company.

We are here to speak against the three anti-ESOP proposals because they will at best be revenue neutral and will mark a set back of 15 years of progressive legislation that was meant to benefit small, closely held companies and the American worker.

Mr. Chairman, as the old adage says, "If it isn't broken don't fix it," and we have come here to say that ESOP's work very well and so don't fix them.

In the material that I prepared for the committee reports, you will notice that it is entitled "A Tale of Two Companies," and this relates the experiences of just two of our clients who have gone through many of the same situations. The reason we chose these two companies is because they are archetypical of not only what we are seeing in our part of the country, but what has been happening in American industry for the past 30 years.

Both companies are located in New York. Both companies were founded by entrepreneurs driven by the pursuit of excellence. Both companies sold themselves to the high-flying conglomerates of the late 1960's, early 1970's, that were built on leverage and the go-go stockmarket of those days.

Both companies bought themselves back from the conglomerate after being poorly run, plundered for their earnings, financially raped, allowed to fall into disrepair and shorn of most of the good employees. Employee benefit plans and employee morale were virtually nonexistent.

The owners who sold to the conglomerate were also not happy because they saw their stock have many restrictions and saw the stock plummet at the hands of bad management. Helpless to sell their stock because of various stock restrictions in the tax laws at that time, and also various securities laws, they were helpless and in effect were forced because of the bad management that they were experiencing to buy back their company, and they had to incur substantial debt and risk to buy that company back.

And then once again after rebuilding their companies to the pinnacle of success they were now faced with the unenviable options that most owners of closely held companies face at retirement. They could either go public which would require them to stay on, sell off the assets, sell back to a conglomerate which they both refused to do because they would be forced to take back corporate paper once again, or just liquidate the business, or sell to someone who was going to be "a competitor." Whether it is a foreign competitor or a U.S. competitor, it really didn't matter.

If they had done one of these unenviable options, it is pretty clear that they would be putting a lot of people out of work, and that was one of the reasons that they chose the ESOP alternative.

The fact of the matter is the inducement for the owners, I believe, was the 1042 rollover and the lack of the other attractive alternatives. The banks, however, were induced by the 50-percent exclusion of interest and the tax deductibility of principal. Without these features they probably would not have lent as much money as was needed to do the deal, nor could they have given it at a reasonable rate that the companies could afford.

The unions involved with both companies approved the programs to save jobs and give their members an enhanced retirement benefit. The employees and successor management have been able to borrow additional funds for growth, in both cases utilizing the ESOP once again.

New employees and the substantial bottom line profit have added to America's prosperity. Both of these companies are real employee-owned success stories. As a matter of fact, my only regret is, because of the papers today, that someone hadn't gotten the word of the success of ESOP's to the chairman of Ogilvie & Mather so that now Madison Avenue wouldn't be leaving New York and going to London.

But we know the truisms that the best run company is the company where the owner works on the premises, and that is really what ESOP's are all about. Please do not limit ESOP's or legislate anti-ESOP proposals. If you require ESOP's to have a pension, there will be fewer ESOP's and fewer pensions. If you care about the retirement of American workers, you know that Social Security can only do so much and pensions are terminating right now in record numbers. Do not doom the vibrant ESOP to the same ineffective fate by requiring a second type of plan.

As a matter of fact in our experience after the debt is paid off on the acquisition of the company most of these plans become very similar to a profit-sharing plan and extra cash will be added.

Also, Congress has seen fit to install as one of the many different laws over the past 15 years the diversification requirements, so that when someone reaches age 55 their portfolio will be diversified for them. If we limit the 50-percent exclusion, the small banks will basically get out of the business, and the reason we feel this will be revenue neutral is most of the big banks are now in a situation where because of their foreign debt exposure they are tax sheltered already.

So interest rates will go up, deductions will go up, and yet Congress will receive no more revenues. And, of course, if we do away with the dividend deduction, as already has been said by one of the other speakers, all we will be doing is saying that ESOP's can only be done by labor intensive companies and most of the success in America right now is from service industry companies and not from the major capital-labor intensive companies of the past.

So we don't want to do away with the dividend, which is the only way that small payroll companies can really afford to do an ESOP. If you want to make American companies more productive, let American workers benefit directly from the fruits of their labor. Good ESOP legislation is good for business. Great ESOP legislation is great for the country, and there is no reason to change it.

Thank you very much.

[The statements of Mr. Carpenter and Mr. Israel follow:]

BENEFIT CONCEPTS NEW YORK, INC.
101 Park Avenue
26th Floor
New York, NY 10178
(800) 234-6000

May 17, 1989

Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Recommendation Against Anti-ESOP Proposals

Dear Committee Member:

A TALE OF TWO COMPANIES

The title of my talk A Tale of Two Companies relates to the experiences of two of our many clients that have ESOPs. We have spoken to hundreds of companies about the pro's and cons of ESOPs and pensions as well as other benefit plans, but these two companies because of their past experiences are archetypical of what is happening in America not only today but over the past 3 decades.

Both companies are located in New York. Both companies were founded by entrepreneurs driven by the pursuit of excellence. Both companies sold themselves to the high flying conglomerates of the late 60's, early 70's built on leverage and the go - go stock market. Both companies bought themselves back from the conglomerate after being poorly run, plundered for earnings, financially raped, allowed to fall in disrepair, and shorn of most of the good employees. Employee benefit plans and employee morale were non-existent. The owners who sold to the conglomerate were not happy as they had restrictions on the sale of their stock - and they watched it plummet in the hands of bad management. Helpless to sell and helpless to change management from their LBO - conglomerate bad ways; both companies and owners incurred substantial debt and risk to buy their companies back. After rebuilding their companies to the pinnacle of success, they were now faced with unenviable options as they faced retirement. Going public would require them to stay on. To wind down their business and retire, they would be forced to sell to a conglomerate and take back corporate paper, or liquidate the business, or sell to a competitor.

Both of these companies had already terminated their pensions because the owners could not get a fair contribution. The group life and medical plans had been cut back as well.

Both of these companies would have been sold or liquidated, which would have led to the loss of most if not all of the employees' jobs. The ESOP became a natural alternative, with the owners utilizing the IRC Section 1042 Tax Deferred Rollover.

The inducement for the owners was the 1042 rollover and lack of other attractive alternatives. The banks were induced by the 50% exclusion of interest and the tax deducibility of principal. Without it they would not have been able to lend as much nor at a reasonable rate. The unions involved approved the program to save jobs, and give their members an enhanced retirement benefit. The employees and successor managements have been able to borrow additional funds for growth. New employees and a substantial bottom line have added to America's prosperity.

We all know the truism that the best run company is the company where the owner works on the premises. That is what ESOP is all about and what makes the company more profitable and productive. Employees can learn what wealthy capitalists have known for a long time, that there are two factors for the creation of wealth; one is labor and wages, the other is capital and dividends. This knowledge will make for a stronger economy and we will have fewer people needing to rely on pensions and social security. We will have a country filled with happy capitalists all going to work at a company that they own, all concerned about the future of America just as you and I are.

Please do not limit ESOPs through these Anti-ESOP proposals. If you require ESOPs to have a pension, there will be no ESOPs and no pension. If you care about the retirement of American workers - you know that Social Security can do only so much and that pensions are terminating in record numbers - do not doom the vibrant ESOP to the same ineffective fate, by requiring a second type of plan. After the debt is paid off most ESOPs become profit-sharing plans for their companies. Now with the new diversification rules, employees will have cash as well as stock in their accounts. If you make ESOPs more like pensions, they will be terminated just as quickly as we are seeing pensions terminated today. If owners cannot benefit from a pension plan they will terminate the plan and change their company to a sub chapter "S" Corporation, so they can be taxed on a 28% basis and only once not twice. Sub chapter "S" invariably appeals to the greed of corporate shareholders so that no new corporate growth is obtained, benefit plans wither away, and pension plans disappear, leaving Americans totally dependent on Social Security.

If you limit the 50% exclusion the small banks will get out of the ESOP business and the banks will charge a higher interest rate which will result in less revenue for Congress - since we all know the big banks have no tax appetite anyway because of their foreign loan exposure. And, if we eliminate the deductibility of dividends we are going in the absolute wrong direction. We will be putting ourselves squarely in the hands of the LBO artist who borrows 10% to buy equity, borrows 30% to place subordinated debt, and borrows 60% to secure senior financing. We will make ESOPs harder to finance for smaller less labor intensive companies, and make them more susceptible to management led LBO's - or the real mistake of being sold to a conglomerate. If LBOs are the disease then ESOPs are the cure.

As the old adage says if it works don't fix it. We are here today, to tell you that ESOPs work, don't fix them. If you want America to prosper, let ESOPs prosper. If you want benefit plans to be more egalitarian let ESOPs flourish. If you want less dependence on Social Security, let people build up their nest egg with the stock of the company where they work. If you want to make American companies more productive, let American workers benefit directly from the fruits of their labors. Good ESOP legislation is good for business, great ESOP legislation is great for the country. There is no reason to change it.

REASONS FOR NOT SUPPORTING ANTI-ESOP PROPOSALS

I. None of the Anti-ESOP Proposals will raise any substantial revenues:

  A. Without the 50% Exclusion banks will merely charge higher interest rates which mean bigger deductions for companies borrowing and since most of the larger banks are tax sheltered this will lead to less not more revenue.

  B. Requiring a pension plan in addition to an ESOP will also be revenue neutral since companies that install ESOPs will receive larger deductions for the pension plan. The requirement will not foster pension plans nor will it foster ESOPs. Instead it will probably foster management led LBO's which will benefit the few and not the many.

  C. The tax deductibility of dividends used to pay back principal will also be revenue neutral since the deduction will cause stock to be credited to the employees' account. Eventually, the stock will be repurchased and taxes will be paid - both by the company on the repurchase and the employee on the sale of stock. The only real affect of this proposal will be to limit ESOPs to larger labor intensive companies.

NEW LEGISLATIVE PROPOSALS

1. Allow ESOPs in Sub "S" Corporations. Remove the 35 person limit on Sub "S" status.

2. Loosen up regulations in multi-investor ESOPs so that they can compete favorably with traditional LBOs.

3. Increase ESOP deduction levels beyond 25% of payroll to facilitate larger ESOPs in companies with smaller payrolls.

4. Allow pension and/or profit-sharing beyond the 25% limit of payroll for ESOPs, or separate ESOPs from other qualified plan limits so that there need be no reduction in a pension plan for an ESOP.

With best regards,

Daniel E. Carpenter

Daniel E. Carpenter, J.D.

BENEFIT CONCEPTS NEW YORK, INC.
101 Park Avenue
26th Floor
New York, NY 10178
(800) 234-6000

May 17, 1989

Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Committee Members:

We are hear to respond to the three anti-ESOP proposals listed in the April 12, 1989 House Ways and Means Committee press release. Our position is in support of the benefits currently provided to ESOPs in the over 15 tax bills passed by Congress since 1974 with emphasis on keeping these benefits intact for the private (closely - held) company.

Our business is employee benefit consulting in all areas of qualified retirement plans including ESOPs, 401(k) plans, profit sharing plans, money purchase pension plans, target benefit plans and defined benefit pension plans. Legislation in the past few years has severely limited the amounts that can be contributed to all types of plans except ESOPs.

The first proposal to eliminate or reduce the 50 percent interest extension allowed financial institutions clearly hurts the small and medium sized firm. ESOPs are complicated and even with the exclusion many banks are reluctant to get into this business. The smaller banks who have the "tax appetite" for these loans are the primary source for loans of $500,000 to $5,000,000. Large companies will have no problem negotiating loans and most of the large banks have no tax appetite because of their LDC debt write offs.

The majority of leveraged ESOPs, where the owner(s) initially sell 30% -40% to the ESOP, are financed by the smaller banks and the exclusion is their incentive to loan the funds. At the same time the cost savings to the ESOP company allows them to be more competitive in the world market.

The second proposal to repeal the deduction for dividends used to repay an acquisition loan will prevent high value, low payroll companies from installing an ESOP. Certain industries with many lower paid workers will find it impossible to install a leveraged ESOP. Under TAMRA 86 the use of a dividend to pay down on a ESOP loan causes more shares to be issued faster to the participants. This "penalizes" the selling shareholders and benefits the employees. America's edge right now is in the "high tech" and service fields where payroll is low because the companies are not as labor intensive. Once again, the enactment of this proposal will hurt small companies and probably not effect large public companies.

The third proposal requiring a company to have more than one qualified plan will prevent many companies from implementing an ESOP because of the current restrictive contribution limits. We are finding that many of our clients and prospective clients have either terminated or are planning to terminate their defined benefit plans. In most cases this has nothing to do with the installation of an ESOP, but rather the voluminous restrictions imposed by Congress. Most small company owners are becoming Sub-S companies and paying the profits to themselves at a 28% tax bracket.

Concern that employees' retirement funds could be in danger because they are concentrated in one stock was mitigated in the Tax Reform Act of 1986 with the diversification requirement at age 55. Furthermore, most ESOPs become "profit-sharing" plans after the stock purchase has been paid off. The employees will at least have something with an ESOP. If the ESOP requires another "retirement" plan, the chances are that the small employer will have no plan rather than an ESOP pension combination, thereby leaving the employee with nothing at retirement.

In closing the privately held companies in America will be facing more foreign competition from Europe in 1992 and need all the competitive advantages we can provide. Studies have shown that ESOP companies increase productivity and this is what we need more of now and in the future. ESOPs and Democracy are not perfect but let us keep them both as they are. It was once said that what is good for General Motors is good for America. Now it is clear that what is really good for America is what benefits small companies. ESOP is great for small business, and small business is America's greatest hope.

Sincerely,

Israel

Donald M. Israel, CPA

Mr. **Russo**. Thank you very much, Mr. Carpenter.

Mr. Israel, do you want to make any comment here or do you have any prepared statement?

Mr. **Israel**. No. My partner spoke and we have the same sentiments. I have a letter that is on file, and this will save you time.

Mr. **Russo**. We will make that a part of the record. Everybody's testimony will be made a part of the record, and I appreciate that.

Mr. Steven Koch, treasurer.

STATEMENT OF STEVEN R. KOCH, TREASURER, EMPLOYEE STOCK OWNERSHIP ASSOCIATION, AND VICE PRESIDENT-TREASURER, THE PEORIA JOURNAL STAR, INC., PEORIA, IL

Mr. **Koch**. Thank you, Mr. Chairman. My name is Steven R. Koch. I am the vice president-treasurer of the Peoria Journal Star in Peoria, IL.

Mr. **Russo**. If it plays in Peoria, it plays everywhere. Right? So, if ESOP's are playing in Peoria——

Mr. **Koch**. You are right. We just became an all-American city, Mr. Russo. [Laughter.]

I am also the treasurer of the Employee Stock Ownership Association, headquartered here in Washington. I testify for the approximately 1,000 ESOP member companies and the approximately 500 associate educational and international members of our association.

The former president of the ESOP Association, Mr. Richard Mendelson, testified before you on February 2 at your hearings on tax policy aspects of mergers and acquisitions. I will not repeat his testimony, except to say that he presented evidence that leveraged ESOP's were involved in a small percentage of corporate debt transactions since 1984, 2 to 3 percent of the number and 5 to 7 percent of the value.

In view of this committee's hearing record, where the voices supporting employer ownership was strong, while those wanting to limit ESOP's were few, we in the ESOP community were surprised by the April 12 committee press release which set forth proposals to limit two important ESOP tax incentives and to mandate a Federal pension plan for ESOP companies only. The ESOP Association strongly opposes all three of these proposals.

The first proposal to repeal the ESOP lenders' 50-percent interest exclusion would significantly reduce the number of future ESOP companies. Before this provision became law, leveraged ESOP companies were few in number. Of the few with significant payrolls only a handful were strong growing companies.

In several instances where an ESOP existed before 1985 in a large company, the employees were the buyers of last resort. This is not the case after DEFRA. No longer are employees the last preferred borrower compared to other financial players such as corporate raiders, LBO firms, and the already rich.

To repeal or reduce the 50-percent interest exclusion would seem to be a declaration of condemnation of employee ownership through ESOP's, except for mostly small companies or distressed companies.

Many of the same arguments made for the 50-percent interest exclusion may be made for the ESOP dividend deduction. By allowing a deduction to pay dividends for ESOP debt, the employees incorporations that are capital intensive can now acquire their employers through the ESOP as well as those employees of a labor intensive company.

Prior to 1987 the ERISA rules prevented the size of the ESOP contribution which pays the debt, freeing up the stock for allocation to employees, from exceeding a percentage of the corporation's payroll, generally 25 percent. But post-1987 dividends also may be used to service the stock acquisition debt, and two of the other speakers have testified to this same issue.

We now turn to the third proposal which would for the first time mandate a Federal pension plan for ESOP companies only. Congress has always endorsed the voluntary private system of employer-sponsored retirement savings plan. There was and has been no indication that anyone in Congress is seriously considering mandating Federal pensions. Furthermore, any defense of this proposal to mandate pension plans in ESOP companies only highlights the injustice of the proposal.

The mandate does not apply to employers who only sponsor one plan, such as a profit-sharing plan, a 401(k) plan, or a stock bonus plan, all of which may be funded as an ESOP with employer stock. The mandate would not even apply to an employer with an underfunded defined benefit plan or a money purchase plan.

Proposal 3 is the perfect coup de grace if the goal is to eliminate ESOP's. Because as proposals 1 and 2 would prevent ESOP establishment in large companies, proposal 3 would stop ESOP establishment in small companies which lack the resources to fund several plans.

Why do we defend ESOP's? Why do we believe? As an executive and employee of an ESOP company, I can tell you why. In December 1986, we borrowed $25 million to fund an increase in employee ownership of the company from 28 to 82 percent. This stock was purchased at $71.45 per share and has an appraised value 2 years later of $125.72, a 76-percent increase in value. I defy anyone who claims our employees would have been better off with a Wall Street diversified portfolio during that period of time.

Five short years after the establishment of our ESOP in Peoria the allocated shares in the accounts of our 482 employee owners were valued at $40,219,000, for an average account balance of $83,441. These account balances will continue to have further significant appreciation as we pay down ESOP debt and release unallocated shares.

In 1987–88, we paid $4 million in benefits to employees, mostly retirees leaving our company. We will pay another $2 million this year. Do not tell me that the Peoria Journal Star and its employees are not benefiting from the ESOP Tax Code provisions or that our ESOP does not benefit our employees.

Before moving to our conclusion, we believe it is noteworthy to say that the first time the Ways and Means Committee reviewed ESOP's in 1985 we defended ESOP's in the face of generally negative articles in the national press. Now 4 years later we sit before you with generally glowing press from the national publications.

We read now that ESOP's really do work in Time, Business Week, Fortune, the New York Times, and so on.

As your colleague, Congressman Jake Pickle said to our convention in 1985, "Ownership is a powerful idea." All over the world people struggle with this powerful idea. More and more people want to turn away from ownership by the State or ownership by a few. So far only the ESOP under U.S. laws and regulations represents a successful model for addressing either concern. We respectively conclude that snuffing out the ESOP here in the United States would be the wrong thing to do.

We appreciate your attention.

[The statement of Mr. Koch follows:]

Statement of Mr. Steven R. Koch

Mr. Chairman, my name is Steven R. Koch. I am the Vice President/Treasurer of The Peoria Journal Star, Inc., 1 News Plaza, Peoria, Illinois 61643.

I am also the Treasurer of the Employee Stock Ownership Association, also known as the ESOP Association, headquartered here in Washington, D.C. at 1100 Seventeenth Street, Suite 310. I testify for the approximately 1000 ESOP company members, and the approximately 500 associate, educational, and international members. Based on our information, the ESOP Association has more company members than any other ERISA-focused association.

The former President of the ESOP Association, Mr. Richard Mendelson, testified on ESOPs and corporate debt, mergers and acquisitions, and LBO's on February 2, 1989.

I will not repeat his testimony except to say that he presented concrete evidence that leveraged ESOPs were involved in a small percentage of corporate debt transactions -- since 1984, 2% to 3% of the number and 5% to 7% of value.

During your earlier hearings, a diverse set of witnesses, not affiliated with the ESOP Association, from Secretary of Treasury Nicholas Brady, Chairman of the FDIC William Seidman, Chairman of the Federal Reserve Board Alan Greenspan, and President of the AFL-CIO Lane Kirkland, endorsed employee ownership and ESOPs in general. We do not make the claim that these leaders endorse each and every position held by the ESOP Association, but we do say to you that these men did not recommend the curtailing of the ability of employees to own their employers through an ESOP.

Towards the end of your hearings, two law professors did suggest an examination of the ESOP tax incentives if the Committee enacted limitations on traditional LBO's. Their recommendation was met with sharp questioning from your Committee member Congressman Harold Ford, who questioned their reasoning. Of course, the Committee has received background materials on ESOPs setting forth many of the same, timeworn attacks on ESOPs that the Committee considered and rejected in 1985.

In view of this Committee's hearing record, where the voices supporting employee ownership were strong while those wanting to limit ESOPs were few, we in the ESOP community were surprised by the April 12 Committee Press Release #13, which set forth in Section G three proposals to limit two important ESOP tax incentives, and to mandate a Federal pension plan for ESOP companies only.

To be more specific about the proposals, they are:

1. The present law rule allowing financial institutions to exclude from income 50 percent of the interest income received with respect to loans to ESOPs or to employers making loans to ESOPs, could be repealed or reduced, in order to reduce the differences in tax treatment between the use of debt and equity in corporate financings.

2. The deduction for dividends paid on employer securities held by an ESOP could be repealed, or could be repealed to the extent that the dividends are used to repay an acquisition loan. (To the extent dividends would become deductible pursuant to other options which may be considered by the Committee, however, a deduction could be allowed for these dividends.)

3. Present law rules could be modified so that an ESOP would not be treated as a qualified plan unless the ESOP was a supplemental retirement plan. Accordingly, the employer would be required to maintain another meaningful qualified plan as a means of protection for participants participating in ESOPs that are 100-percent leveraged, or are the only qualified plan maintained by the employer. As an alternative, the exposure of plan participants, in the event a company does not repay an ESOP loan, could be limited by providing that the acquisition of shares by an ESOP could not be 100-percent leveraged.

The ESOP Association strongly opposes all three of these proposals, and urges that the Committee not consider them.

The first proposal to repeal the ESOP lender's 50% interest exclusion, which is Code Section 133, would significantly reduce the number of future ESOP companies. This provision of law was adopted by Congress in the 1984 tax act, known as DEFRA. Before DEFRA, leveraged ESOP companies were few in number -- some estimates are fewer than 100 companies had significant leveraged ESOPs before 1985. These companies with leveraged ESOPs usually had fewer than 100 employees. Of the few with significant payrolls, only a handful were strong, growing companies.

In several instances where an ESOP existed before 1985 in a large company, the employees were the buyers of last resort. These distressed buyouts were troublesome to some observers, but most have survived their economic crisis, and today are strong. We believe the ESOP had a role in the recovery.

After 1984, however, the DEFRA ESOP incentive for lenders allowed the employees and those wanting to establish an ESOP to compete for the acquisition of healthy companies with larger payrolls. In other words, no longer were employees the least preferred borrower compared to the other financial players, such as corporate raiders, LBO firms, and the already rich.

To repeal, or reduce, the 50% interest exclusion would seem to be a declaration of condemnation of employee ownership through ESOPs except for mostly small companies, or distressed companies.

The second proposal to repeal or reduce the DEFRA provision allowing the ESOP corporate sponsor to deduct for tax purposes dividends paid on ESOP stock would also lower the number of future ESOPs.

Many of the same arguments made for the 50% interest exclusion may be made for the ESOP dividend deduction, which is Code Section 404(k). By allowing a deduction to pay dividends for ESOP debt, the employees in corporations that are capital intensive can now acquire their employers through the ESOP as well as those employees of a labor intensive company.

Allow me to explain the reason. Prior to 1987, the ERISA rules prevented the size of the ESOP contribution, which pays the debt freeing up the stock for allocation to employees, from exceeding a percentage of the corporation's payroll, generally 25%. But post-1987, dividends may be used to service the stock acquisition debt.

The ESOP dividend deduction also has the advantage of eliminating the double taxation of corporate income. Many experts have told you that the solution to the growth of corporate debt is not to tax corporate income twice. Income on ESOP stock, paid as dividends, represents taxing income only once. In fact, the ESOP Association recommended on February 2 that all dividends on all stock, not just ESOP stock, be fully tax deductible. This position is in accord with the theories of Dr. Louis Kelso, the originator of the ESOP concept.

Now we turn to the third proposal, which would, for the first time, mandate a Federal pension for ESOP companies only. Needless to say, this proposal, for a Federally mandated pension plan, has the ESOP community at a high state of concern.

First of all, Congress has always endorsed the voluntary private system of employer sponsored retirement savings plans. There was, and has been, no indication that anyone in Congress is seriously considering mandating Federal pensions.

Furthermore, any defense of this proposal to mandate pension plans in ESOP companies only highlights the injustice of the proposal. The mandate does not apply to employers who only sponsor one plan such as a profit-sharing plan, a 401(k) plan, or a stock bonus plan, which all may be funded, as an ESOP, with employer stock. The mandate would not apply to an employer with an under-funded defined benefit plan, or money purchase plan. Even more incredible, an employer who has no plan of any kind would be treated better under proposal number 3 than would an ESOP company.

Clearly, the proposal to micromanage the affairs of an ESOP company through a Federal mandate sends chills down the spine of the thousands of U.S. ESOP companies. Proposal 3 is the perfect coup de grace if the goal is to eliminate ESOPs, because as proposals 1 and 2 would prevent ESOP establishment in large employers, proposal 3 would stop ESOP establishment in small companies, which lack the resources to fund several plans.

Finally, proposal 3 declares that ESOPs are the worst ERISA plan compared to all others. We reject that contention vigorously. We say that we have provided to this Committee and to other Committees, evidence over and over that ESOP companies, as a general rule, put more money in the pockets of employees than any other ERISA plan. These evidence has come from specific companies, and from general research.

We know that some that claim money, or even lots of money, has nothing to do with retirement income security. Let us tell you that that theory does not "play in Peoria". The first stock was purchased by our ESOP in March 1984. Five short years later the allocated shares in the accounts of our 482 employee-owners were valued at $40,219,000, for an average account balance of $83,441. These accounts balances will continue to have further significant growth as we pay down ESOP debt and release unallocated shares.

This observation leads us to observe that if the Committee wishes to reopen the debate and deliberations about ESOPs which occurred during your work on the Tax Reform Act of 1986, then let's do so.

We are certainly desirous of presenting the overall case for ESOPs, as we did to you in 1985 instead of trying to defend ESOPs in the context of corporate raiders and LBO's, a world of flip, fast-buck transactions, that frankly the ESOP community is not part of.

Why do we want to defend ESOPs? Why do we believe? As an executive and employee of an ESOP company, I can tell you why. The Peoria Journal Star, Inc. publishes the largest daily circulation newspaper in Illinois outside the city of Chicago. In addition, we publish six special interest magazines with both domestic and international circulation.

In December 1986, we borrowed $25,000,000 to finance generally a transaction increasing the employee ownership of the company from 28% to 82%. This stock was purchased at $71.45 per share and has an appraised value two years later of $125.72, a 76% increase in value. Given the 1987 stock market crash, I defy anyone who claims our employees would be better off with a diversified, Wall Street portfolio.

During the same two-year period, we paid $7,880,000 in dividends to reduce the $25,000,000 ESOP debt. These dividends resulted in shares worth $13,860,000 being allocated to employee-owner accounts because of the increase in appraised value. In 1987-88, we paid $4,000,000 in benefits to employees leaving the company, and these were mainly retirees. We will pay another $2,000,000 this year.

Do not tell me that the Peoria Journal Star and its employees are not benefitting from the ESOP tax code provisions, or that our ESOP does not benefit our employees. I know better.

Before coming today, I reviewed the testimony of the many other ESOP company people who have testified before you, or given you statements. They said the same things, in general, that I have just said.

Before moving to our conclusion, we believe that it is noteworthy to say that the first time the Ways and Means Committee reviewed ESOPs, we defended ESOPs in the face of generally negative articles in the national press. Keep in mind, the press skeptics were commenting at a time when these were very few well-known ESOP companies. In those days, the ESOP Association witness would sit before you and, in essence, say the reporters just did not know what an ESOP really did for employees and the company.

Now, four years later, we sit before you with generally glowing press from the national publications. We read now that ESOPs really do work in Time, Business Week, Fortune and so on.

Why the difference? The answer is simple. Unlike four years ago when viable ESOP companies were not known to the press, today reporters can actually see ESOP companies in action because companies such as Weirton, Avis, Lowe's, Healthtrust, Amsted, Old Stone Bank, and many others, are easy to find. The proof is in the pudding. ESOPs work.

Finally, the Committee asks how the proposals in the April 12 Press Release will affect the ability of U.S. corporations to compete in the global economy.

When someone asks about international economics and ESOPs, then ESOP supporters do get excited.

We judge the effectiveness of ESOP companies by looking at what foreign leaders and their economists think of ESOPs. Just as the old saying "Imitation is the highest form of flattery" is true, the interest of other nation's in applying ESOPs concepts in their countries is the evidence that ESOP companies compete well.

For example, recently the powerful Soviet paper IZVESTIA said in a March 21 article on ESOPs, and U.S. ESOP leaders like Dr. Kelso and Jeff Gates, and I quote from the paper, "Regrets to acknowledge that the capitalistic countries are far ahead of us in the search of ways to develop the incentive to encourage workers toward a more effective productivity."

In the past 18 months, a growing percentage of the ESOP Association's staff time is spent with delegations from overseas, wanting to learn about ESOPs and employee ownership.

In a few days, delegations from 11 nations are coming to the ESOP Association's convention. They will come from the U.K., the U.S.S.R., China, France, Denmark, Costa Rica, Poland, and Egypt, where U.S. aid recently assisted the employee purchase of a tire factory in a transaction similar to a leveraged ESOP, to name just a few countries.

The U.K. probably has more U.S.-style ESOP companies than any other nation besides the U.S. The estimate is 50. There is even an ESOP Association-like organization in the U.K. While someone has proposed to this Committee that key ESOP tax incentives be emasculated, Prime Minister Margaret Thatcher's 1990 budget recommends tax incentives, similar to ours, for the creation of ESOPs.

As your colleague Congressman Jake Pickle said to our convention in 1985, "Ownership is a powerful idea."

All over the world people struggle with this powerful idea. More and more people want to turn away from ownership by the state, or ownership by a few. So far, only the ESOP, under U.S. laws and regulations, represents a successful model for addressing either concern.

We respectfully conclude that snuffing out the ESOP here in the U.S. would be wrong.

We appreciate your attention.

Mr. RUSSO. Thank you very much, Mr. Koch.
Mr. Menke.

STATEMENT OF JOHN D. MENKE, PRESIDENT, MENKE & ASSOCIATES, INC., SAN FRANCISCO, CA

Mr. MENKE. Thank you, Mr. Russo.

I have one thing in common with T. Boone Pickens, and that is I come from Amarillo, TX. After having said that, let me suggest that there is no other similarities. My firm specializes in ESOP's, which I view as the absolute reverse or converse of LBO's.

I think to put the problem in perspective we need to stand back for a moment and say what is an LBO? Is it good or evil? And I have to come down on the side that it is basically evil, and I have to take issue with everything that T. Boone Pickens said.

Originally, I suppose LBO's started out in a good vein. It was the case that our American companies were underleveraged and they weren't showing the kind of returns on capital they should have shown. So it started out with a meritorious objective, but it quickly got out of hand with the invention of junk bonds and PIK's and what have you.

So now what we have, if you want to look at it in all honesty, is a pyramid of bribery. We have the shareholders who were picked off and enticed by high prices far in excess of the real value of the company. We have investment bankers getting big investment banking fees. We have the bankers getting points. We have the investors, as pointed out in Mr. Lowenstein's testimony, the mutual funds are getting phoney dividends and interest that they are claiming they are earning and they are not even receiving in cash. So we have a situation that is out of control.

I am sick and tired of hearing the comments of Mr. Pickens that, well, the market will decide this and let that take care of it. The market didn't handle the S&L crisis. It didn't handle the green mail crisis. We need some regulation.

I am sick and tired of hearing that LBO's only occur in these undervalued companies here and there. They occur because there is some greed around and there is some quick money to be made. Let's face the truth.

Pick up the Wall Street Journal, even today there is a company there that is probably going into bankruptcy. It only has $400 million of revenues but it has $1 billion in debt and it managed to lose $1 billion in one-quarter. How can that be? It only has $60 million in cash. It can't even pay the interest, much less the principal.

Now Pickens would say, well, that is an exception. There are good deals and there are bad deals. But having been involved in LBO's, I know full well that all LBO's follow a pattern, a template, if you will. They are all designed to pay interest only, and most of them are only—don't even pay all of that on a large chunk of their debt. So it is a gigantic crap shoot. There is no payment of principal in large part, so that you have to depend upon a vibrant stock market or somebody to bail you out 5 years down the line when the first principal finally becomes due.

So what is going to happen. We have got rampant speculation. Eventually the bubble will burst, and then the foreign buyers really will come in here. We are going to drive out the people who really do need to borrow money for legitimate reasons. We are going to concentrate ownership of capital. We are going to jeopardize our future competition. Existing companies won't be able to borrow money to replace equipment that they need.

We are going to get to Gresham's Law of Management. We are going to get management that is in there for the quick buck. I don't understand how the financial managers are going to manage these companies better than the corporate managers. And we are going to set a bad precedent throughout the world for what capitalism is all about.

Now, having dramatized the problem to some extent, I come to the solution, which is so simple I don't understand why it hasn't already been suggested. The solution is to deny the interest deduction on all debt that is used for buyouts. With all due respect to Mr. Galef, he has completely missed the point. There is two kinds of debt. There is working capital debt and there is buyout debt. I am not suggesting in any way that we deny the deduction even on junk bonds if it is for corporate growth. But conversely, if it is for a buyout of stock, then I think that the deduction should be denied across the board, whether it is junk bond debt or whatever.

Why should the tax law subsidize transfers of private wealth? I just don't understand it. We don't allow deductibility of stock redemptions, but we somehow allow the deductibility interest on those stock redemptions. Why is that? That is a complete anomaly.

So, if we allow the deductibility of interest, we haven't created any of the problems that Mr. Galef is worried about. We have companies that are just as competitive as ever because they can borrow all the money they want and they can deduct the interest on it. But what they can't do is go around buying and selling their stock all the time. They have to put the money into plant and equipment where we are going to be more and more productive.

So my proposal leaves companies fully protected. I also fundamentally and thoroughly disagree that we are giving foreign companies some sort of advantage because if a foreign buyer has a strategic reason for buying a company, he is going to buy it anyway. But if it is a financial buyer, he really isn't going to come in and buy a company when he knows he can't turn around and sell it very well because the buyer would probably be an American company and the American company can't deduct the interest. So we are not putting our companies at a competitive disadvantage.

The ESOP issue—there are two issues that have not been discussed, really. I think maybe ESOP's have been criticized because they are being used by managements to fend off hostile tender offers. I don't see that that is a bad thing. I think it is a good thing. It results in the company's being a lot less leveraged, even if they are doing it for the wrong reasons.

But we have got plenty of clout to police that already. If the plan is put in because of the wrong reasons, the SEC will throw it out anyway and the courts will throw it out. I don't think you can condition the tax policy or the tax deductibility on what the motivation was. You can't be that subjective.

There has also been some criticism of ESOP's that they sometimes replace pension plans, and that is true in public companies.

But that is true with LBO's as well. I don't think that you can say—I personally prefer pension plans. I think they are the best form of retirement plans. But they are the worst form of incentive plan, and some people can't afford retirement plans. Some companies in order to be competitive in the world economy need to have plans that are focused on productivity, which would be an ESOP plan. So I don't think we can mandate that every company has to have the highest and best retirement plan. They have to have the flexibility of other plans as well.

So I would recommend that we continue the ESOP provisions as they are and that we deny the interest deduction on LBO debt that is used for buyout.

[The statement of Mr. Menke follows:]

STATEMENT OF JOHN D. MENKE
ON BEHALF OF
MENKE & ASSOCIATES, INC.

WAYS AND MEANS COMMITTEE HEARINGS
ON TAX POLICY ASPECTS
OF MERGERS AND ACQUISITIONS
MAY 16, 1989

I am appearing today as founder and President of Menke & Associates, Inc.

Menke & Associates, Inc. is the most active firm in the nation in designing and installing Employee Stock Ownership Plans ("ESOPs") for privately held companies.

After graduating from the Yale Law School in 1967, I worked as a tax attorney for the law firm of Louis O. Kelso, Inc. until 1974 when I founded Menke & Associates, Inc. to specialize in ESOP activities. Menke & Associates, Inc. designs and installs approximately 100 ESOPs per year, primarily for privately held companies. Because of my long and early involvement in ESOP activities, I have probably designed more ESOPs than anyone else in the country.

I would like to address my comments to the two following issues: options modifying the current tax treatment of corporate interest and options relating to Employee Stock Ownership Plans.

OPTIONS MODIFYING THE CURRENT TAX TREATMENT OF CORPORATE INTEREST

Recommendation #1:

Interest Deductions Should Be Denied on All Debt Incurred to Finance Stock Redemptions or Leveraged Buyouts.

Mr. Chairman, I would recommend that the Internal Revenue Code be amended to eliminate all interest deductions with respect to debt incurred to finance stock redemptions and leveraged buyout transactions, for the following reasons:

1. The primary objective of a stock redemption or of an LBO transaction is to transfer stock ownership from one group of shareholders to another group of shareholders. I ask you, Mr. Chairman, why should the tax code subsidize transfers of wealth between private individuals? In this regard, it should be noted that individuals are allowed to deduct investment interest only to the extent of investment income, if any. Similarly, individuals are prohibited from deducting interest on residential mortgages in excess of $1 million. Yet, if these same individuals incorporate, they can borrow billions of dollars of debt, and deduct millions of dollars of interest for the purpose of purchasing corporate stock.

   It should also be noted that corporate stock redemptions are not a deductible expense to the corporation. This nondeductibility is based upon the principle that a stock redemption is not an ordinary and necessary business expense. Yet, through an apparent oversight, the interest on the money that is borrowed to make a stock redemption is fully deductible. It would seem that this anomaly should be eliminated by denying the deductibility of interest on corporate debt that is used to make stock redemptions. Since an LBO is simply another form of stock redemption, interest paid on corporate debt used to finance leverage buyout transactions should also be nondeductible.

2. Stock redemptions and leveraged buyout transactions serve to concentrate ownership of capital. The inevitable result of a stock redemption or a leveraged buyout transaction is to reduce the number of shareholders of a corporation. In recent years, the reduction of corporate shareholders and the resulting concentrating of ownership in the hands of a few shareholders has become epidemic. Over the last five years, it has been estimated that two to three times as much stock has been bought back from the market as has been offered in the market. To the extent this shrinkage is attributable to stock redemptions or corporate buybacks, this trend is not alarming. However, to the extent this shrinkage is attributable to leveraged buyouts, this trend is alarming. In the case of R. J. Reynolds, for example, $25 billion of equity that was previously broadly held among hundreds of thousands of shareholders, is now concentrated in the hands of half a dozen corporate or institutional shareholders. I ask you, Mr. Chairman, why should the tax law subsidize concentrations of ownership of this magnitude?

Mr. Chairman, I am not suggesting that we throw out the free enterprise system. As a principal owner of three privately held companies, I am an ardent defender of the free enterprise system. However, I am suggesting that as members of Congress and as members of the Ways and Means Committee, it is incumbent upon you to regulate the free enterprise, so that the system benefits the public at large, not merely the privileged few. A subsidy that concentrates ownership in the hands of a privileged few is indefensible.

Mr. Chairman, at the beginning of the Industrial Revolution, there were no child labor laws; there were no laws regulating wages and working conditions; there were no health and safety regulation. The unbridled success of early capitalism led to an incredible concentration of ownership in the midst of general poverty. These conditions fueled the flames of socialist and fascist revolutions in France, Spain, Italy, Germany and Russian, and resulted in Communist takeovers in Eastern Europe and Russia. In summary, history teaches us well that nothing can be more destructive to the free enterprises system than the failure to regulate its excesses and abuses.

The United States is still regarded around the world as being the leader of the free enterprise system. Our system is now the model that is increasingly being adopted in Southeast Asia and even in Eastern Europe. We cannot afford to have this model critiqued and discarded because of abuses associated with LBOs.

3. Leveraged buyouts are destroying our ability to compete in the world economy. Over the next 10 to 20 years, we will be facing increased competition from Japan, Hong Kong, Singapore, Korea and the European Economic Community. We simply cannot compete in this worldwide economic competition if we are devoting most of our financial resources to buying and selling securities rather than replacing outmoded plant and equipment.

At the end of World War II, Japan and Germany were forced to rebuild their entire industrial productive capacity. As a result, today Japan and Germany are the two strongest economic powers in the world. If we are going to compete effectively with Germany, Japan and Southeast Asia, we too must rebuild our industrial capacity. If, however, we continue to draw off our life blood, we will be less and less competitive, and our economy will become more and more anemic.

4. Despite arguments to the contrary, leveraged buyouts do not increase long-term shareholders values, and do not increase long-term productivity and competitiveness. In short, leveraged buyouts generate an extra measure of profits for the shareholders who happened to hold stock in the company at the time of the buyout. They do nothing, however, to increase the long-term value of the company. Because of the high degree of debt undertaken, most LBO companies are worth a mere fraction of their former worth after an LBO transaction.

   Also, because of the high degree of debt incurred, LBO companies are forced to cut back on R&D expenditures and on expenditures necessary for long-term growth and development.

   More importantly, LBO transactions divert management attention from the issue of maximizing corporate growth and productivity to the issue of maximizing personal wealth. As a result of the current tax subsidy for LBOs, no corporate manager can consider himself successful unless he has at least attempted an LBO transaction.

5. It is not true that denying the interest deduction for LBO interest would put foreign acquirers at a competitive advantage. Most foreign acquirers are strategic buyers. Strategic buyers buy companies for strategic reasons, not for tax reasons. Moreover, even foreign financial buyers would be restrained by limiting the interest deduction. Assuming that the foreign buyer could deduct the interest on his acquisition indebtedness in his own country, which is often not the case, the foreign buyer must still consider that when he sells the company, the logical buyer will be an American company, which will not be willing to pay a premium price, since the American buyer will not be able to deduct the interest on the acquisition debt.

Recommendation #2:

The Interest Deduction on All Junk Bonds Should Be Eliminated.

Mr. Chairman, the greatest abuse in LBO transactions occurs not when one privately held firm acquires another privately held firm or when one publicly held firm acquires another publicly held firm, but when a publicly held firm is acquired by an LBO firm. In these transactions, a huge portion of the company's profits are siphoned off by means of interest deductions; the company becomes less competitive, and the ownership of wealth becomes incredibly concentrated.

Accordingly, if the Committee does not see fit to deny the interest deduction with respect to all stock redemptions and leveraged buyout transactions, it should, at a minimum, deny the interest deduction on all junk bonds issued in connection with leveraged buyouts of public companies. This interest exclusion, however, should be applied to all such transactions, whether or not hostile. As George Roberts of Kohlberg, Kravis and Roberts has stated on many occasions, the only difference between a hostile and a friendly offer is whether or not management agrees to the offer at the end of the day.

Mr. Chairman, I have reviewed a number of these leveraged buyout transactions. In most cases, the company's pretax income is barely sufficient to pay the deductible interest expense. Any repayment for principal depends upon corporate growth over and above the current growth rate, the sale of corporate assets, or a subsequent public offering. Since all of these options can be illusory during a recession, it is highly predictable that a fair percentage of these buyouts will fail during the next recession. Buyouts that have already failed include Revco and Freuhauf. The jury is still out on Beatrice; however, it appears in trouble. Several others are already in default of their loan covenants.

We should, of course, do nothing to exacerbate the precarious position of existing transactions. However, eliminating the interest deduction on future junk bond issues should go a long way toward eliminating these types of transaction.

OPTIONS RELATING TO EMPLOYEE STOCK OWNERSHIP PLANS

Recommendation #1:

The 50% Interest Exclusion for ESOP Loans Should Not be Repealed or Reduced.

Mr. Chairman, I would recommend that the 50% interest exclusion for ESOP loans not be repealed or reduced, for the following reasons:

1. ESOPs are the reverse of LBOs. LBOs necessarily concentrate ownership of capital. ESOPs necessarily broaden the ownership of capital. Given the fact that we have subsidized LBOs and stock redemptions for the past 70 years, we should now subsidize for the indefinite future the only technique that we have for broadening the ownership of capital in privately held firms.

   Tax subsidies are absolutely essential if ESOPs are to continue to exist. Of the ESOP transactions that I have been involved with over the past 20 years, I can say with the utmost confidence that 99% of these transactions would not have happened if there had not been a financial subsidy in the transaction. In general, corporations make financial decisions entirely on the basis of economic considerations. Absent a tax subsidy, there is no reason for a corporate owner to sell his company to his employees, when it is usually quicker and easier to sell it to a third party.

2. Since ESOPs have proven to be the only effective method for fending off hostile offers, ESOPs should be encouraged and even subsidized. Under the recently enacted Delaware statute, a company cannot be merged with the acquiring company, unless the acquirer obtains approval of 85% or more of the shareholders. This has prompted many public companies to establish ESOPs which borrow the funding necessary to purchase 15% of the outstanding stock. The 50% interest exclusion enables the plan to borrow at a lower rate of interest. The lower interest cost is a further inducement for companies to enact this type of defense.

   The alternative to using an ESOP as a defense to a hostile takeover offer is either to be acquired in a 100% leveraged buyout, or to engage in a defensive recapitalization. Under either of these approaches, the company will be almost 100% leveraged. Allowing an interest deduction for a 15% leveraged purchase is certainly less of a revenue drain on the Treasury and less of a financial strain on the company, than allowing the company to be acquired or recapitalized for 100% of its value.

3. A recent study by the General Accounting Office shows that every $1.00 of tax subsidy spent on ESOPs generates $2.56 to $16.99 of employee benefits. Since these employee benefits will be taxed when the distribution is made upon death, retirement, or termination of employment, the net effect is to increase government revenues, not to decrease government revenues. If revenue enhancement is the objective, denying the 50% interest exclusion would be a revenue mistake.

4. There is no evidence that ESOPs have been overleveraged, or that ESOPs have ever utilized junk bonds. If ESOPs were to use junk bond financing, however, then I would recommend that the interest deduction be denied, just as if the company had used junk bond financing.

Recommendation #2.

The Deduction for Dividends Paid on Employer Securities Held by an ESOP Should Not be Repealed.

Mr. Chairman, I would recommend that the deduction for dividends paid on employer securities held by an ESOP should not be repealed for the following reasons:

1. As indicated above, ESOPs should be encouraged and subsidized, since ESOPs are one of the few means we have for broadening the ownership of capital.

2. In many cases, a company's payroll is too low in comparison to its value. As a result, the normal contributions may not be sufficient to amortize a loan to purchase a significant amount of stock. This problem is avoided by paying a deductible dividend to the plan. The plan uses these dividends, together with company contributions, to repay the acquisition loan. Without this provision, companies in certain industries would not be able to utilize an ESOP.

3. The use of a deductible dividend enables public companies to minimize the cost of using an ESOP, when the ESOP is used to fend off a hostile tender offer. As mentioned previously, if the ESOP borrows money and purchases 15% of the company stock, this will generally be effective under Delaware law in preventing a hostile takeover offer. Accordingly, to the extent that Congress wants to discourage hostile takeover offers, it should encourage and even subsidize ESOP transactions.

   The principal objectives of ESOPs are to broaden the ownership of capital and to create a more equitable distribution of capital. These objectives are accomplished whenever ESOPs are used to fend off hostile takeovers and whenever ESOPs are used in lieu of LBOs. Nevertheless, ESOPs have been criticized when they have been used to fend off hostile tender offers on the grounds that such ESOPs are not installed for the proper purpose of increasing employee productivity. This criticism is unfounded because the S.E.C. and the courts have the power, on a case-by-case basis, to invalidate an ESOP if it is not implemented for the purpose of fostering employee productivity. The ESOP was upheld in the Polaroid case based upon a finding of fact that Polaroid had gone to great efforts to foster a participative style of management. This kind of case-by-case analysis, however, cannot be used for tax purposes. The tax-deductibility of interest and dividends cannot be conditional upon an analysis of management's objectives in implementing an ESOP.

4. As indicated previously, there is no evidence that ESOPs have been used as hostile takeover devices. If ESOPs are used for this purpose, then the law could be amended to provide that the dividends would not be deductible to the extent that they are used to finance hostile acquisitions.

Recommendation #3.

ESOPs Should Not Be Limited to Supplemental Retirement Plans.

Mr. Chairman, the present law should not be modified to limit ESOP to being supplemental retirement plans for the following reasons:

1. Under existing law, companies are free to choose the type of plan that they want, whether it be a profit sharing plan, a defined benefit pension plan, an employee stock ownership plan, or no plan at all. This flexibility has existed since qualified plans were first authorized by the Internal Revenue Code of 1926. This flexibility is needed in order to encourage companies to adopt qualified retirement plans. Some companies cannot afford to adopt defined benefit pension plans. Hence, they are free to adopt profit sharing plans. Similarly, some companies in their early years of development can only afford cash profit sharing plans, rather than deferred qualified profit sharing plans. Congress would be ill-advised to mandate a particular type of plan for all companies, or to mandate that a company can have a certain type of plan only if it also maintains an additional type of plan.

2. As a matter of fact, ESOP plans are, on the average, far more generous than all other types of plans. The typical contribution rate to a profit sharing plan is 6% to 8% of payroll, and the typical contribution rate to a pension plan is 10% to 12% of payroll. The typical contribution rate to an ESOP is 15% to 25% of payroll. Accordingly, employees receive far greater benefits under an ESOP than under other types of qualified plans. It is true that under an ESOP all of the eggs are in one basket. However, this fact is offset by three factors. First, the contribution rate to an ESOP is usually two to three times greater than to other qualified plans. Accordingly, even if the value of the company stock falls, the employee will still receive a larger benefit than he would under another type of plan. Secondly, most ESOPs have other liquid investments which are accumulated in order to repurchase stock from employees who die or retire. These funds would be available for distribution, even if the value of the company's stock falls. Thirdly, under the 1986 amendments all ESOPs are now required to provide that each participant can diversify up to 25% of his account balances after he reaches age 55, and up to 50% of his account balances after he reaches age 60.

3. The proposal to require that an ESOP could only be used as a supplemental retirement plan apparently comes from union employee groups. There have been a number of public companies which have been taken private. In these cases, the company's pension plan has been terminated and replaced by an ESOP. In

order to put this into perspective, however, one must realize that the number of ESOP going-private transactions is less than 2% of all going-private transactions. In most going-private transactions, an LBO firm acquires the company and terminates the plan without replacing it by anything. In the case of ESOP buyouts on the other hand, the pension plan, if it is terminated, is replaced by an ESOP which is usually at least as favorable, and frequently more favorable, than the prior pension plan. If an ESOP can only be used as a supplemental retirement plan, then most companies would provide no retirement plan whatsoever. Further, why should an ESOP buyout be required to provide two retirement plans, whereas other types of buyouts would not be required to provide any type of retirement plan?

4. Under existing law, union employees are already fully protected. Pension plans that are established for union employees are established under collective bargaining agreements. These pension plans cannot be unilaterally terminated by the company. Since union employees are already protected, I see not need for further protections.

5. Mr. Chairman, I would further point out that the proposal to treat an ESOP as a supplemental retirement plan has nothing to do with the tax treatment of corporate debt and equity. If the tax rules with regard to qualified plans are to be changed, they should be changed with respect to all companies, not just companies that are leveraged or that are involved in hostile takeovers.

Recommendation #4.

The Law Should Not be Amended to Prohibit ESOPs from Being 100% Leveraged.

Mr. Chairman, I would recommend that the law not be amended to prohibit ESOPs from being 100% leveraged. If ESOPs were prohibited from being 100% leveraged, ESOPs would have to either use prior funds from a prior pension and profit sharing plan or would have to bring in funds from outside investors. If outside investors are brought in, the ownership percentage of the employees would be diluted. As a practical matter, outside investors would not be interested in coinvesting with an ESOP. As a result, leveraged ESOPs would cease to exist. Similarly, if prior funds of a prior pension or profit sharing plan were used, then the employees would be in even greater jeopardy than they would be by using a 100% leveraged ESOP.

CONCLUSION

The Industrial Revolution, born in 1750, is still less than 250 years old. Since its inception, capitalism has increased the standard of living for everyone. The question remains, who should benefit from this increased wealth? Should it be a handful of people whose only contribution is the knowledge of how to structure debt and equity instruments? Or should it be the founders of the company, the managers, the workers, and the employees who together create an enterprise that produces goods and services? In an LBO, the wealth goes to the financiers. In an ESOP, the wealth goes to the entrepreneurs, the managers, the workers, and the producers. Public policy demands that the Congress do everything it can to discourage LBOs and to simultaneously encourage ESOPs.

For the past several years I have been one of two U.S. delegates to the Wider Share Ownership Council in London. This organization is sponsored by the English, French and German stock exchanges, and is devoted to broadening the ownership of capital in Europe. Earlier this year, England became the first European country to adopt ESOP legislation. I can report that this would not have happened but for the example that the U.S. has set in adopting ESOP legislation here at home.

I can also report that to some degree, ESOPs have contributed to the thawing of the Cold War between the U.S. and the Soviet Union. See the attached Exhibit A.

Mr. Chairman, I can see the day when ESOPs will be prevalent throughout Western Europe, Eastern Europe, including Poland, Hungary, Czechoslovakia and Russia, and even in China. Earlier this year, for example, thousands of cooperatives were authorized for the first time in Russia.

Mr. Chairman, the ESOP promises a new era of equitable distribution of capital. We must do everything we can to give it a chance to succeed.

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EXHIBIT A

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РАБОТНИК И ХОЗЯИН

Как совместить их в одном лице, показывают международный опыт

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В. РУТГАЙЗЕР,
доктор экономических наук, профессор.

ОКСФОРД — МОСКВА.

Exhibit A

Mr. **Russo**. Thank you very much, Mr. Menke.

Mr. Dorgan? I think he was happy to hear our testimony, by the way.

Mr. **Dorgan**. Thank you, Mr. Chairman.

Let me observe that I was not present for much of your testimony. I was off at a Ukrainian Famine Commission meeting, and that is true with most other members of the committee. There are, unfortunately, as in the schedule here on Capitol Hill always several things happening at once that require your attendance.

But I was able to last evening and this morning read much of the testimony that was going to be offered today, including the testimony of this panel. The purpose of the 2 days of hearings is to try and complete the record and develop a more comprehensive analysis of what is happening, what are the advantages and disadvantages of what is happening, and what might be some public policy remedies, if any, to respond to it. And I think your statements have been important contributions to that.

Mr. Kelso, I have also begun reading your book. There are things that take precedence to it that are lighter reading from time to time, but I am continuing to try to move on through it, and it is also a useful piece of information in the better understanding of ESOP's and the role they play in today's society.

So I don't have any specific questions. You are correct, Mr. Chairman, Mr. Menke's comments were comforting to me and I will send them to Boone Pickens so that he receives your regards.

I want to thank all of the people who appeared on this panel. I wish I could have been here for the entire presentation, but I have had a chance to read the record.

Thank you.

Mr. **Russo**. And, as the chairman, let me just thank all of you for your presentation. It was certainly an enlightening discussion, the importance of ESOP's.

And, Mr. Kelso, I will enjoy reading your book.

Mr. **Kelso**. Thank you, sir. Could I make one short comment?

Mr. **Russo**. Sure.

Mr. **Kelso**. The point has not quite been made anywhere in the hearings that I know of that ESOP debt and non-ESOP debt are totally different animals. There is virtually no comparison. In fact, they are almost opposites.

The ESOP debt starts to metamorphasize itself into equity the moment the plan closes, and it is all short-term financing—3-, 5-, 6-, 7-year financing—and then it is equity. It is no longer debt.

Furthermore, that employee ownership is savings under the definition of savings in the American economy. That is to say, it is paid for, owned equity in a capital company.

So the characteristics of it are far from well understood, and I think if this committee wanted to really cut the American deficit—well, really, cut the American annual taxes and deficit in half year after year, all they have to do is enact things that will equip the American people with capital ownership. Because the bulk of the taxes, some 60 to 70 percent, goes to support underpowered people. The reason they are underpowered is that we live in a highly industrialized world. Capital produces some 90 percent of the goods and services and they don't own any. We need to equip them.

That meets Mr. Lincoln's definition of the purpose of government perfectly. It is to do for the people what they can't do for themselves. They can buy capital and pay for it but they have got to have binary techniques to do it.

Mr. RUSSO. We appreciate the words of wisdom, and I thank the panel. Thank you very much.

This concludes the hearings and this meeting is adjourned.

[Whereupon, at 2:15 p.m., the hearings were adjourned.]

[Submissions for the record follow:]

STATEMENT OF EDWARD I. ALTMAN, MAX L. HEINE PROFESSOR OF FINANCE, LEONARD N. STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY

Altman's Position on the Harvard Default Rate Study

The recent circulation of an unpublished study by Harvard Business School colleagues (Asquith, Mullins and Wolff) about default rates on high yield "junk" bonds has created some unfortunate confusion and misdirected sensationalism. In this study, the authors compare their "aging process", of bonds issued over the period 1977-1986, with other methods for assessing the risk of default. They conclude that junk bonds are far riskier than any previous study has shown. Some of the confusion comes from the authors' inferences, and those found in The Wall Street Journal (April 14) and The Boston Globe (April 16), among others, that the Asquith et al. methodology is substantially different from, and that it precedes, my own. In fact, this is not the case. Their work is similar to my own "Mortality Rate and Bond Performance", paper, first presented at a Financial Management Association panel in October 1987 and published as a working paper in February 1988. The mortality paper has undergone the academic peer review process and will be published in the American Finance Association's, Journal of Finance in September, 1989.

The Asquith group admit (p. 9) that their work is incomplete since they do not measure net returns to investors in junk bonds. You simply cannot say anything about performance of securities unless you measure both risk and return. The mortality study calculates the return performance on all risk categories (bond ratings) of corporate, non-convertible debt by looking at returns, including losses from defautls, over the period 1971-1988; also calculated for the period (1977-88) that the Asquith group examined. I conclude that investors in Single-B rated bonds (the dominant junk bond type) earned $44.67 for every $100 of investment more than what they would have earned on default risk-free U.S. Treasury bonds over a 10 year period. This is despite a mortality rate of about 32% for 10 years. And, investors in BB-rated bonds, the highest rating class in the junk bond arena, do substantially better than any other class, earning $76.37 per $100 of investment more than Treasuries over 10 years.

My mortality rates are about the same as what Asquith et al. find. An early version of my paper was quoted in Newsweek (December 7, 1988) as showing a 36.2% rate for 10 years through 1986. The amount actually lost on portfolios of junk bonds is considerably lower since investors recover, on average, about 40 percent of par value if they sell just after default. So, Asquith et al.'s results are nothing new and misleadingly incomplete. It is unfortunate that the daily press chose to sansationalize them.

Additional confusion is caused by the Asquith study's mixing the concept of cumulative defaults with average annual rates. The latter is the actual amount of defaults experienced in a given year as a percent of the entire pool of such securities existing in the market at that time. Recently (1985-1988) such annual rates of default have averaged around 2.5 percent per year and about 2% over the period 1978-1988. The two measures are quite different. The average annual rate is useful for investors measuring performance and setting reserves for losses over one year intervals. These investors are concerned with what proportion of their portfolio will default and result in losses over some finite interval. If one would annualize cumulative defaults as measured by the mortality concept (or the aging approach) then a rate of 2.5%, compounded annually over a bond life of 12 years, would produce cumulative defaults of about 27 percent; or about 30 percent if one simply sums the annual rates. In fact, since we have such scanty data on junk bonds for ten years, most thoughtful analysts only consider about a 5-6 year experience in setting loss reserves.

The junk bond field is still in its early days and benefits from serious scholarly studies of all types. Though incomplete, and not original, the Asquith, Mullins, and Wolff study makes a contribution and for that it is welcome. The Journal and Globe reporting on the subject, however, was misleading.

An alternative piece from the press that I believe tells the story better is "Junk Bonds, Nothing New", appearing in the April 17th issue of Barron's.

From the Board

Should We Regulate Junk Bonds?

by Edward I. Altman, Max L. Heine Professor of Finance, Leonard N. Stern School of Business, New York University

The recent indictments against Drexel Burnham Lambert and several of its employees and the huge RJR Nabisco takeover have rekindled interest in banning or restricting high-yielding "junk bonds." These low-grade, fixed income securities have grown dramatically and now represent almost one-quarter of the total corporate, publicly traded bond market, with over $180 billion outstanding. Rather than cripple or kill junk bonds, which have valuable uses in America, we should provide adequate safeguards for them and other risky assets. And we should encourage equity financing, rather than discourage debt.

Financial institution regulators are wrestling with the so-called "moral-hazard" issue, whereby the government provides deposit insurance for institutions, such as S&Ls, whose health and safety could be in jeopardy if they purchase junk bond assets in lieu of traditional investments. Legislators and the Federal Reserve Board are rethinking the evils of junk-bond-financed takeovers, even going to the extreme of contemplating the elimination of the tax-deductibility of interest expense on high-coupon, low-rated bonds, in effect viewing them as equivalent to preferred stock, rather than debt.

Should we be concerned about the issuance of increasing proportions of debt—and, in particular, by its use in financing major restructurings? Should federally insured institutions be restricted from investing in high-yield bonds? For that matter, how emotionally charged is the term "junk bonds" itself? Can it be said of them, as Juliet said of Romeo, "tis but thy name that is my enemy"?

In my opinion, junk bonds play an important role in our financial system. They have been around in various forms for well over 60 years, financing major capital expenditures of emerging and established firms. Were it not for their use in the controversial, but legitimate, restructuring of corporate America, they would be much less controversial today.

Removing the tax-deductibility of the interest payments on such bonds would be a monumental blunder. It would weaken our nation's ability to compete with foreign firms, which not only use far more leverage than U.S. firms, but also benefit from tax subsidies on common and preferred stock dividends. If Congress wants to be constructive, then it should consider the fact that the current system of taxing stock dividends at both the corporate and the personal level is punitive and serves to reduce the incentive for firms to issue new equity securities.

It would make more sense to give investors a tax break on common dividends than to eliminate tax-deductibility of interest payments. Instead of taxing 100 per cent of cash dividends, for example, stockholders could receive a tax reduction of, say, 50 per cent of the cash dividends received. Of course, the huge government deficit hinders such constructive tax changes to the extent that they reduce tax revenues. Congress would need some courage to promulgate such a change at this juncture, but the benefits would become evident in a very short time.

Insurance Company and Thrift Holdings

Insurance companies are a major investor in high-yield bonds, with holdings of publicly traded debt in excess of $40 billion. Still, life insurance companies in some states are allowed to invest only a set proportion of their assets in high-yield bonds, while other risky or riskier assets are not regulated.

Thrifts, while holding less than 10 per cent of total high-yield bonds outstanding, are perhaps even more susceptible than insurance companies to restrictive regulation, because of the taxpayers' liability implied by deposit insurance. Federally chartered thrifts can invest up to an arbitrarily determined 11 per cent of assets in low-quality bonds. Such restrictions are misplaced, especially in view of the current state of the thrift industry.

Thrifts have squandered billions of dollars on unsuccessful real estate ventures and loans, poor asset-liability management, and an outdated and undercapitalized insurance system. As a result, over 1,000 S&Ls have disappeared in the last few years. The public and legislators should worry more about traditional banking practices and less about the growing number of S&Ls that are trimming back on real estate assets and venturing into newer areas like high-yield junk bonds. Rather than condemning such investments, we should applaud efforts by S&L investment committees to raise overall profitability by prudent, diversified, high-yield investing.

According to the Federal Home Loan Bank Board, about 150 S&Ls are now investing in high-yield bonds, and I expect this number to increase. I am not aware of any thrift institution that has failed because of losses from investments in marketable financial instruments. Higher-yielding assets make an institution more competitive, and through their returns, add to its capital base—a resource most financial institutions will need as they approach new capital standards in 1992.

Based on the historical return-risk performance of high-yield bond portfolios, it is difficult to support restriction arguments. High-yield junk bonds have outdistanced returns on risk-free and investment-grade fixed income securities over the last decade, with average annual returns to investors of about 12 per cent. And this continues to be the case, despite periodic predictions of the market's downfall. A recent GAO-sponsored research study performed by Wharton Econometric Forecasting Associates concluded that, on a risk-adjusted basis, high-yield bonds ranked as one of the most profitable investments for thrifts, coming in second to credit card activities.

Of course, the future may not continue to approximate past performance, but that is the nature of any risky market. The appropriate way to handle uncertainty is to set aside adequate reserves and mandate other prudent policies, not to regulate arbitrarily.

Alternatives to Restrictions

While there is no robust evidence of excessive risk in these investments, high-yield bonds nevertheless have a considerably higher historical default rate than investment-grade corporate debt securities. Rather than imposing restrictions on junk bond holdings, one possible solution would be to treat these and other security investments in the same way that traditional loans are handled. Traditional loans for real estate development, mortgages, commerce and industrial purposes sometimes do lead to default and loss of principal and interest to lenders. Capital reserves are thus set aside to cover expected loan losses. The problem of late has been inadequate reserves in these traditional areas and lack of effective diversification.

A policy of setting aside additional reserves would, of course, discourage investments in junk bonds by institutions that have a shaky capital base. But that is precisely the kind of institution that is now of such concern to public regulators. And setting clear guidelines for reserves and diversification would reduce industry uncertainty about arbitrary legislation and regulation and thus probably encourage some thrifts and insurance companies to invest in these high-risk, higher-return assets.

Capital-Reserves Determination

How much should thrift institutions set aside against possible losses? As one measure, the average yearly default rate on high-yield bonds between 1978 and 1988 was 1.90 per cent. But *losses* to investors were considerably less—about 1.3 per cent per year (about 1.6 per cent per year in the last four years). This is because defaulted bonds have historically sold at an average rate of about 40 per cent of par value after default—an important liquidity component of publicly traded bonds compared to other types of debt. (The recovery rate has been 50 per cent in the 1985–88 period.)

Another guideline for determining reserves is to use an amount based on the "mortality" of corporate bonds over time, categorized by the original issuer's bond rating. I have estimated these mortalities and losses from default over the 1971–87 period; many financial institutions, particularly insurance companies, are very comfortable with the results. Reserves based on this concept result in average provisions similar to aggregate high-yield-debt default losses measured the traditional way, but they can be estimated more precisely according to the credit quality of each portfolio. (This analysis is available from the author.)

Many critics of historical-default-rate approaches point to the expectation that defaults will rise significantly during the next recession, especially with the recent amount of leveraged transactions. One cannot reject this thesis, but a calm, dispassionate analysis would reveal that even if the default rate reaches 10 per cent in one or more recession years, the loss to investors is within acceptable limits—probably 6 to 7 per cent per year. As promised yield spreads on high-yield bonds over Treasuries are close to 4.5 per cent today, loss rates of 6.5 per cent would result in net (loss) return spreads relative to default-risk-free Treasuries of a relatively small 2 per cent. Of course, recession-level defaults might panic investors into selling the better high-yield bonds at just the wrong time, i.e., when prices are low relative to intrinsic values. This should be avoided.

If regulators treat risky investments like risky loans, then a 1.75 to 2.00 per cent loss reserve per year would be appropriate for a diversified portfolio of high-yield bonds. These reserves are flexible and can be changed to reflect new conditions. Adequate diversification should also be stressed, because diversification can ensure average return and risk performance and help reduce the possibility of unacceptable losses from defaulting securities. Faced with the requirement of loss reserves, investment managers, acting in concert with other thrift officers and with boards of directors, would be forced to consider whether the return from high-yield bonds justified the set-aside amount.

1001 Connecticut Avenue, N.W., Suite 1201
Washington, D.C. 20036
202 • 223 • 2600

June 2, 1989

Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U. S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

This letter is written on behalf of the American Automotive Leasing Association (AALA) in connection with the House Committee on Ways and Means' consideration of various federal tax policy options relating to leveraged buyouts (LBOs), mergers and acquisitions and recent increases in corporate debt. AALA's interest relates to the options which deal with the full or partial elimination of deductions of interest expense, and we urge, for reasons set forth, that if any limitations are placed on the interest expense deduction, they should not be applicable to the automotive leasing industry.

AALA's members engage in the long-term leasing of automobiles and trucks, mainly to business users. The lessees include large corporations leasing fleets of hundreds of vehicles each, as well as small companies leasing a few vehicles each. AALA members have over two million vehicles on lease.

Automotive leasing is a unique and extremely successful means of providing vehicles and transportation services to American businesses for use in connection with the production and distribution of goods and services throughout the economy and the country. Automotive lessors provide a large portion of the wheels on which the U.S. economy depends and moves, and year after year lessees have found automotive leasing to be a cost-effective, efficient and more desirable alternative to the purchase of fleets of vehicles. Automotive leasing has been providing these important services and valuable assets for over 50 years, it has become an essential component of the nation's growing economy, and it continues to grow in size and scope. Our industry has been so extremely successful because, as stated, it provides efficient and cost-effective transportation services for sophisticated businesses which must compete in an increasingly competitive domestic and world economy.

Vehicles are expensive assets. Even a small lessor of 5,000 vehicles, with an average cost per vehicle of $12,000, has an investment in assets costing $60,000,000. Lessor fleets of 25,000 vehicles are not unusual, and larger lessors may own 100,000 or more vehicles. Automotive leasing is an extremely capital intensive and highly leveraged industry.

Interest is a major expense of doing business for automotive lessors -- no less than for banks and financial institutions -- and this is inherent in the nature of the business. The leased vehicles are turned over very rapidly, being sold by the lessor, on average, between two and three years after purchase. No efficient method other than borrowing exists in practice to finance the lessors' purchases of this magnitude.

American Automotive Leasing Association

Increasing equity to meet the requirements of these recurring purchases is simply not timely or efficient.

The debt and interest expense incurred by lessors are used to enable lessors to purchase vehicles for lease to lessees. This use of debt is a far cry from borrowing to finance high-stake mergers, hostile takeovers, or the acquisition of another company's "good will."

This method of financing the acquisition and leasing of vehicles has been used by automotive lessors for over 50 years in a highly competitive marketplace. The major firms in the industry have high credit ratings, in part because the debt is secured by real assets which continue to have real value in a readily available after-market. The availability of the interest deduction to automotive lessors has not been a source of uneconomic ventures, nor has it resulted in any abuse of the Federal income tax system.

Leasing is, in large measure, a financial transaction which offers an alternative to the financing by banks and financial institutions of the purchase of cars, vans and trucks. The users of the vehicles lease them from lessors rather than borrow from a financial institution to fund their purchases. Automotive lessors are analogous to, and compete directly with, banks and financial institutions. As is the case with financial institutions, automotive lessors have traditionally had high debt/equity ratios.

Obviously, a limitation on the tax deductibility of interest expense would seriously harm the automotive leasing industry and the businesses which it serves. For example, a general limitation on the interest deduction based on some ratio of debt to equity, without regard for the special leverage requirements of automotive lessors, would adversely affect the industry and its customers.

AALA requests that the Committee in its deliberations give full recognition to the special needs of the automotive leasing industry for the continued availability of the interest deduction. Limitations on the interest deduction that may be adopted in connection with leveraged buyouts, mergers and acquisitions -- or, indeed, more generally, -- should not be applicable to penalize the automotive leasing industry. The disruption of this very important leasing industry would have drastic consequences for the domestic motor vehicle industry and the country's economy.

Certainly this industry should not be treated less favorably, with respect to the interest deduction, than the banks and financial institutions with which it is in direct competition. Otherwise, automotive lessors would be placed at a severe competitive disadvantage with banks and financial institutions, many of which participate in automotive leasing and all of which provide loans to finance the purchase of vehicles. Moreover, such an adverse impact on competition would severely harm the economy because it would eliminate the existing important advantages and efficiencies which automotive leasing now provides to American businesses.

Sincerely yours,

Douglas S. Brown

Douglas S. Brown,
President

cc: Committee members

AICPA
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, N.W.
Washington, DC 20004-1007
(202) 737-6600
Telecopier (202) 638-4512

May 31, 1989

The Honorable Dan Rostenkowski
United States House of Representatives
Washington, DC 20515

RE: Tax Policy Aspects of Mergers and Acquisitions

Dear Chairman Rostenkowski:

The Members of the House Ways and Means Committee recently submitted LBO options to you. You requested an evaluation of these options using various concepts, and we wish to respond.

On March 14, 1989, I testified before the Committee on Ways and Means on behalf of the American Institute of Certified Public Accountants (AICPA) at hearings concerning the Tax Policy Aspects of Mergers and Acquisitions. The position of the AICPA communicated in the testimony was that the correction of the perceived problems created by the increased LBO activity should not and most likely could not be affected by changes in the tax laws. Examples of unsuccessful attempts to "correct" perceived abuses such as the repeal of General Utilities, Section 279 limitation, Section 385, and denial of deductions for "golden parachutes" under Section 280G were included in that testimony.

The AICPA's position with respect to the attempt to restrict such debt-financed acquisitions via changes in the Internal Revenue Code is unchanged - the tax law should not be changed to restrict such activities.

The staff of the Joint Committee has prepared an excellent study of LBO options. As indicated in the AICPA's previous testimony, if Congress feels compelled to implement one of these options, option B3b is the least objectionable to the AICPA. Although, as previously stated, the tax law should not be changed to effect Congress' desired curtailment of LBO activity.

We believe that the same overriding comment applies with equal conviction to the LBO options recently submitted to you. Several of these alternatives are the same as those submitted by the Joint Committee; some are new. The AICPA has the same specific concerns with respect to these new suggestions as it did with those included in the report prepared by the Joint Committee:

- **Complexity.**

  The complexity added to the tax law will defy compliance and enforcement.

- **Scope.**

  The practical difficulties of identifying the targeted transactions are immense. In addition, any simple tactic, such as a blanket disallowance of a deduction for interest will impact the wrong targets.

- **Efficiency and Effectiveness.**

  In the area of mergers and acquisitions, the tax law has frequently proven to be an inefficient and ineffective vehicle to discourage the use of highly leveraged transactions.

- **Favoritism.**

  Foreign purchasers not subject to restrictive U.S. tax laws, will be accorded an advantage over their American competitors.

If you would like to discuss the topic further, please contact me, Mr. Paul Schecter, Chairman of the Corporations and Shareholders Taxation Subcommittee of the AICPA Tax Division, or Dr. Donald Skadden, Vice President - Taxation.

Sincerely,

Arthur S. Hoffman

Arthur S. Hoffman, Chairman
Federal Taxation Executive Committee

cc: Robert J. Leonard, Chief Counsel
Committee on Ways and Means

STATEMENT OF THE HONORABLE CASS BALLENGER
THE HOUSE WAYS AND MEANS COMMITTEE
HEARINGS ON TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

SUBMITTED FOR THE RECORD
MAY 26, 1989

Mr. Chairman, I appreciate the opportunity to share my views on Employee Stock Ownership Plans (ESOPs) with the Committee.

I know something about ESOPs because my company in Hickory, North Carolina established one thirteen years ago. I started an ESOP at my company due to the bureaucratic red tape created by the Employee Retirement Income Security Act (ERISA). An ESOP seemed the best way to help my employees and avoid this mess!

Today, most of the employees (86 percent) at my company participate in the ESOP. The remaining employees participate in an 401(K) plan.

The company stock was purchased at $2.30 a share and has increased in value to $60.00, the stock is worth almost twenty-six times as much. The employees now own 32 percent of the stock in the company, valued at a little more than $3,174,000.

The dividend payments to employees have remained small so that more money remains invested in the company. Because my family still retains a controlling interest in the company, this ensures that employees receive greater benefits.

I want to defend ESOPs for several reasons. Giving employees a meaningful stake in a company provides them with economic security and a say in the company profits. In addition, ESOPs cut the tax burden for small businesses and help protect it from takeover attempts. Finally, and most importantly, ESOPs help boost productivity for companies, enhancing our overall economic competitiveness in the world market.

As someone who has had a successful ESOP for a number of years, I strongly believe that this benefit should not be threatened by congressional tinkering. Proposals to repeal or reduce the 50 percent lender's interest exclusion for a qualified securities acquisition loan would lower the number of future ESOP companies.

Suggestions to repeal or reduce the deduction for dividends paid on stock in an ESOP would also reduce the number of future companies. The ESOP dividend deduction also eliminates the double taxation of corporate income.

Congress should continue to promote the free-enterprise system rather than continually find ways to regulate it out of existence.

STATEMENT OF
GILBERT BUTLER, PRESIDENT OF
BUTLER CAPITAL CORPORATION
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

May 16, 1989

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to express my views on options presented by members of the Committee for legislative changes relating to mergers, acquisitions, leveraged buyouts and corporate debt.

Butler Capital Corporation (BCC) has been engaged since 1981 in structuring and financing management leveraged buyouts, primarily of small to medium-sized companies. Prior to organizing BCC, I served as President of Term Capital Management Company and as a Vice President of Morgan Guaranty Trust Company. For over twenty years I have been involved in leveraged buyouts, credit evaluation, and analysis of public and private securities.

I. OVERVIEW

In connection with this Committee's hearings in March of this year, I submitted a detailed description of BCC's activities. As described in my prior testimony, the companies acquired in management buyouts sponsored by BCC have flourished following the buyouts, showing significant increases in operating profits, employment and long-term spending for capital improvements. The impressive performance of these companies is, in my opinion, largely attributable to three factors: the powerful incentive created by giving management a significant entrepreneurial stake in a company; BCC's philosophy of investing primarily in non-cyclical, basic manufacturing industries; and BCC's careful structuring of a company's debt to allow adequate cash flow, not only for payments on the debt, but for expansion of the business as well. I believe my prior testimony demonstrates that responsibly structured management leveraged buyouts--and particularly those of small to medium-sized companies--serve a valuable function in our economy and should not be discouraged.

The testimony of other witnesses before the Committee also demonstrated that leveraged buyouts are not generally harmful to acquired companies or the economy. To the contrary, a number of highly regarded witnesses, including government officials, academicians, and businessmen, testified that leveraged buyouts help to efficiently allocate resources in the economy and that many companies show a dramatic increase in productivity after a leveraged buyout. These witnesses further testified that corporate debt is not at inappropriately high levels, that leveraged buyouts do not result in serious revenue losses (and may even result in revenue gains), and that the level of pension fund assets invested in leveraged buyouts is responsible. In short, leveraged buyouts serve an important and desirable function in the economy.

It is true there is not unanimity on these issues and that some leveraged buyouts--at least with the benefit of hindsight--raise legitimate concerns. But, in the face of the large body of persuasive testimony as to the generally beneficial effects of leveraged buyouts, it would be a mistake for Congress to enact tax legislation to discourage or penalize all leveraged buyouts because of a few isolated problems.

This Committee's hearings have focused not only on leveraged buyouts but also more generally on defects in the corporate income tax system. The hearings have renewed debate on the impact of the disparate tax treatment of debt and equity, and led to increased analysis and understanding of the ramifications of the dramatic changes made by the Tax Reform Act of 1986. While my testimony concludes that each of the options has serious drawbacks, it should not be read as opposing the fundamental objective of seeking to fully understand and cure any defects in the corporate tax system. To the contrary, I strongly support the goal of a more rational and neutral system. But the questions involved are complex, and there is no crisis that requires immediate action. Moreover, proposed solutions may involve unintended consequences, particularly with respect to international competition. There is no reason to act hastily and thereby risk trading one flawed system for a system with equal or even greater flaws.

II. LEGISLATIVE OPTIONS

A. Exception for small transactions.

The Committee has requested testimony with respect to limiting the applicability of any option to transactions involving a relatively high dollar threshold, such as $100 million, or interest incurred in excess of $10 million. The Committee also requested comments on the purchase of assets or stock of wholly owned subsidiaries of other corporations and friendly acquisitions of stock of closely held corporations.

As stated above, legislation specifically directed at leveraged buyouts is not warranted and would discourage economically productive transactions. If the Congress nevertheless decides to enact such legislation, an exception for small, non-hostile transactions would be appropriate. A management leveraged buyout is a traditional means of transferring ownership of a closely held company. Alternative methods of disposing of closely held companies, such as a sale to a larger corporation or a public offering, have significant drawbacks. These alternatives do not permit the managers of the company to acquire a significant entrepreneurial stake in the company. In my experience, managers who have a substantial amount of their own net worth invested in a company have a powerful incentive to operate the company in the most economically efficient and productive manner. Further, sales to larger corporations sacrifice the independence of small to medium-sized companies, which have proven to be a vital source of innovation and competition in our economy. Finally, the market for initial public offerings of stock has been depressed since the October 1987 market break. Notwithstanding the recovery in the market for established publicly-traded companies, initial public offerings are not now a viable alternative for transferring ownership of a company and do not permit selling shareholders to realize full value on their stock.

To summarize, management leveraged buyouts are an important source of capital for facilitating transfer of a privately held company and, in many cases, will be the only source of capital that permits the selling shareholder to receive a fair price and allow the company to remain independent. Consequently, if legislation designed to discourage leveraged buyouts is enacted, it should contain an exception for such transactions. An exception of the size suggested in the Committee's options--$100 million transactions or $10 million annual interest--seems appropriate, if indexed for inflation and variations in interest rates.

B. Options Modifying the Corporate Tax Treatment of Interest.

For purposes of discussion, the proposals to restrict the deductibility of interest can be grouped as follows: (1) proposals to reduce the disparity in the tax treatment of debt and equity; (2) proposals to disallow deductions for debt with certain equity characteristics; (3) proposals to disallow interest on "bad" debt; and (4) a proposal to restrict deductibility of original issue discount (OID).

1. Proposals to reduce the disparity in the treatment of debt and equity (Options B-4, B-5, and B-8).

Option B-4 would disallow the deduction for a portion of interest expense and allow a partial deduction for dividend expense. Option B-5 would fully repeal the deduction for corporate interest and allow a shareholder credit for dividends paid. Option B-8 would repeal the corporate interest deduction and allow a percentage deduction based on overall capital.

Because payment of a dividend is not deductible by a corporation while the payment of interest is, our tax system is biased in favor of debt financing. This bias could be eliminated by removing the double taxation of dividends. Some have suggested that this bias could as easily be reduced either by restricting the deductibility of interest or by a combination of dividend relief and reduced interest deductibility. While this notion is at first appealing, upon closer examination any restriction on the deductibility of interest raises serious concerns that are not presented by dividend relief.

Most importantly, any restriction on the deductibility of interest would increase the cost of debt capital to U.S. corporations and place them at a serious disadvantage *vis a vis* foreign corporations enjoying full deductibility of interest. Further, an increase in the cost of debt capital would have a greater impact on long-term than on short-term investments and would thus tend to discourage long-term investments by U.S. corporations. Although I understand that some tax theorists would argue that at some point the distinction between debt and equity is somewhat tenuous, American businesses compete in a global economy where that distinction is well accepted and where interest expense is generally deductible in full.

More fundamentally, proposals to restrict the deductibility of interest miss the point. The problem with the current tax system lies not in the treatment of debt, but in the treatment of equity. Interest paid for the use of money is a legitimate business expense that should be deductible, just as rent paid for the use of tangible property and royalties paid for the use of intangible property are deductible. A related problem with restrictions on deductibility of interest is that complex rules would be needed to prevent avoidance of the restrictions through interest substitutes. For example, instead of purchasing an asset, a corporation might simply rent it for an extended period and deduct the rental payments.

In addition, if restrictions on the deductibility of interest were coupled with a nonrefundable tax credit for interest recipients, corporate debt would be a less attractive investment for tax-exempt entities and foreign investors--the resulting shifts in investments would have a serious impact on the capital markets. Restrictions on interest deductibility, coupled with a tax credit, would tend to push corporate interest rates down because taxable investors would be willing to accept a lower interest rate due to the fact that the credit would increase their after-tax return. Lower interest rates, however, would make corporate debt less attractive to tax-exempt entities and foreign investors because they could not use the tax credit (unless it were refundable). These investors would be likely to shift their investments to non-corporate debt, such as government securities, or non-debt investments. The need to attract new investors to replace tax-exempt and foreign investors would tend to push rates back up. Because corporations would in all likelihood not be able to reduce interest rates enough to offset the increased corporate taxes resulting from disallowance of the interest deduction, the cost of debt capital would be increased. Moreover, because tax-exempt entities and foreign investors would shift their investments away from corporate debt (and thereby avoid indirectly bearing a tax on interest income), it is problematic whether such a proposal would raise revenue.

For these reasons, I urge the Committee to reject Option B-4, which would disallow the deduction for a portion of interest expense and allow a partial deduction for dividend expense. Similarly, I urge the Committee to reject Option B-5, which would fully repeal the deduction for corporate interest and allow a shareholder credit for dividends paid. This proposal, as written, does not provide for a debtholder credit and thus would simply shift the incidence of double taxation of corporate profits from dividends to interest. If interest recipients were allowed a nonrefundable credit, then the likely impact on the market described above would be a problem. Option B-8, which would repeal the corporate interest deduction and allow a percentage deduction based on overall capital, also would simply shift the incidence of double taxation from dividends to interest. Moreover, the impact of this proposal on different corporations would vary dramatically, depending upon their current mix of debt and equity capital. All of these proposals would increase the cost of debt capital for United States corporations compared to their foreign competitors and seriously impede their ability to compete in international markets.

2. Proposals to disallow deductions for debt with certain equity characteristics (Options B-3, B-6, and B-7).

Option B-3 would disallow deductions for interest payments on "junk bonds" issued in excess of a specified threshold amount. Option B-6 would disallow interest deductions above a specified rate. Option B-7 would partially disallow interest deductions if a specified debt/equity ratio was exceeded. These proposals are apparently premised on the theory that debt in certain situations is more properly viewed, at least in part, as equity. Each option suffers from the same defects of oversimplifying a complex problem and imposing rigid standards on diverse situations.

Taxpayers, courts and the Treasury Department have wrestled for years with the often elusive distinction between debt and equity. The courts have used a multi-factor analysis including factors such as the rights and obligations of the parties in the event of default, rights to participate in management, the apparent intention of the parties, whether debt and equity interests are proportionately held by the same parties, and the overall capitalization of the company. No one factor is controlling. Similarly, under section 385, Congress contemplated that Treasury regulations would use a variety of factors to distinguish debt from equity in different situations, and that the factors would differ from one situation to another.

Although present law is not entirely uniform or predictable, it at least attempts to reflect the variety of factors that are significant. Options B-3, B-6 and B-7, on the other hand, although admittedly simple and hence easily administered, are arbitrary in their operation and do not reflect the dynamics of the capital markets or the differences in capitalization of different industries.

Option B-3, which would deny an interest deduction for certain "junk bonds", is similar in some respects to section 279 in current law. Section 279 has proven ineffective because its detailed requirements are easily avoided. The proposal to deny an interest deduction on junk bonds would probably suffer a similar fate, if the definition of a junk bond were narrow enough so as not to encroach upon legitimate debt. Moreover, the proposal would penalize small, high-risk, and start-up companies that cannot borrow on more favorable terms.

Option B-6, which would disallow the interest deduction on corporate debt with an interest rate in excess of a specified rate, is overly simplistic. Such a rule could not accurately reflect the numerous variables that affect the cost of capital for a particular company. Such a proposal also would seriously disadvantage small start-up companies and those in high-risk industries.

As proposed, the rule also presents a number of technical issues. A specified number of percentage points over the applicable federal rate (AFR) will not result in a consistent measure of acceptable corporate interest rates for a number of reasons. First, because of market variables, the spread between AFR and high-yield corporate debt fluctuates significantly. Second, it is not clear whether the specified rate should be measured by percentage points above AFR, a particular ratio to AFR, or a combination of the two. For example, a spread of six percentage points would result in a specified rate of 15% when AFR is 9% and a specified rate of 18% when AFR is 12%. Although the spread between the specified rate and AFR remains consistent (as measured by percentage points) in this example, the ratio of the specified rate to AFR changes from 5:3 to 3:2. If the spread were measured by a ratio of 5:3, instead of by six percentage points, the specified rate would be 20%, instead of 18%, when AFR is 12%. Third, the mechanism for determining the specified rate should take into account the effect of the inflation component of interest rates on the spread between AFR and corporate rates.

Option B-6 would either disallow the entire interest deduction on debt with an interest rate in excess of a specified rate or would disallow only the amount of interest in excess of the specified rate. Disallowance of the entire amount would be appropriate only if the debt were considered to be more properly classified as equity. One can argue that at some point an interest rate is so high and the likelihood of payment so uncertain that the lender should be viewed as sharing in corporate earnings and risking loss of its investment in a manner similar to a stockholder. However, because so many factors are involved in distinguishing debt from equity, the rate would have to be exceedingly high (e.g., in excess of 25% in today's market), if it alone were to be used as the distinguishing factor between debt and equity. It is doubtful that such a provision would have much impact. Further, because of the "cliff" effect that would be created by disallowance of the entire amount, disallowance of only the excess over the specified rate would be far preferable.

Option B-7, which would disallow interest deductions if a specified debt/equity ratio is exceeded, is also overly simplistic. It would be necessary not only to take into account historical differences among industries and fluctuations among business cycles, but to develop a means for classifying the numerous businesses that do not fit neatly into a particular industry. More fundamentally, any effort on the part of the federal government to establish mechanical debt/equity ratios would deprive both the industrial and financial markets of needed flexibility.

In summary, each of the proposals to disallow interest deductions on debt viewed as having certain equity characteristics has serious drawbacks. The "junk bond" proposal would likely be ineffective, and it is doubtful whether the debt/equity proposal could be sufficiently refined to provide needed flexibility. Although the proposal to disallow interest deductions in excess of a specified rate also has deficiencies, on balance, it has more to recommend it than the other options. If Congress were to give further consideration to such a proposal, it would be necessary to fully understand the relationship between AFR and corporate rates. It would also be very important to set the interest rate high enough so that mainstream businesses would not suddenly find that bona fide debt issued at normal corporate rates is treated in part like equity.

3. Proposals to deny interest deductions on "bad" transactions (Options B-1 and B-2).

Option B-1 would disallow interest deductions on debt incurred in hostile acquisitions. Option B-2 would disallow interest deductions on debt incurred to finance mergers determined by the Federal Trade Commission not to be in the public interest. As stated at the outset, legislation to discourage leveraged buyouts in general or even a class of leveraged buyouts would be a mistake. Although BCC does not finance hostile acquisitions, it nevertheless recognizes that such acquisitions, if responsibly structured and accomplished with the informed consent of the shareholders, may be just as economically efficient as non-hostile acquisitions. Moreover, whether a transaction is in the public interest probably cannot be accurately projected, and it would be inconsistent with a fundamental premise of our economy to substitute such a governmental determination for market judgment.

To the extent that Congress decides to address the issue of hostile acquisitions, the securities law is a more promising tool than the tax law. Improved disclosure requirements for takeover activity, coupled with the requirement that all shareholders be given adequate information in order to make an informed decision as to whether to sell, would perhaps slow the activities of corporate "raiders," while still permitting economically efficient transactions to move forward. In addition, tighter regulation of certain "creeping acquisition" practices and enhanced protection for minority shareholders could also be beneficial. In any event, the tax law with respect to corporate acquisitions should not be changed in a manner that could easily discourage all unsolicited acquisition offers.

4. Proposals to defer interest deductions for OID until amounts are paid (Option B-9).

Option B-9 would defer interest deductions on original issue discount (QID) obligations in which debt replaces corporate equity until such amounts are actually paid. The proposal might be tailored to apply only to OID obligations held by tax-exempt entities and foreign persons. As an alternative to postponing the interest deductions of the issuers, Option B-9 would treat OID income from obligations that replace corporate equity as unrelated business income for tax-exempt entities.

It is not clear what perceived problem this option addresses. Under current law, the general rule is that original issue discount is taxed to the lender and allowed as a deduction to the borrower on an accrual basis. While it is true that in the case of a tax-exempt lender the borrower is allowed a deduction while the lender is not taxed on an equivalent amount, this asymmetry arises from the special tax treatment accorded tax-exempt entities and not from any defect in the OID rules. Indeed, in the case of cash interest payments, the borrower is allowed a deduction for interest and a tax-exempt lender is not taxed on the interest.

This option might be justified on the ground that, in some cases, the risk of default is so great that the accrued interest is akin to contingent interest, and should therefore not be deductible until paid. The option is not, however, so limited. This alternative justification for Option B-9 would be most applicable to long-term subordinated debt with a very low stated interest rate (or none at all in the case of a zero coupon bond), sold at a steep discount from the full amount of the debt. Any attempt by Congress to address certain extreme cases, however, should be carefully tailored so as not to penalize OID debt that has a legitimate business purpose.

In sum, if the OID rules are defective, these defects should be addressed in a targeted manner. The fact that an exempt entity is not taxable on interest income, however, is not directly relevant to the OID rules or the policies underlying these rules. Hence, any changes in the OID rules should not arbitrarily penalize debt issued to tax-exempt organizations. Finally, any rule that required corporations to determine the tax status of bondholders would be burdensome to corporations and would discourage investment by some investors, particularly foreigners.

C. Options Modifying the Current Tax Treatment of Equity Distributions by Corporations (Options C-1, C-2, and C-3).

The double taxation of corporate earnings has long been a source of concern and proposals for some form of dividend relief have been put forward from time to time. These proposals have much to recommend them. First, many of our foreign trading partners provide some relief from the double taxation of corporate earnings. Second, to the extent that corporate integration or dividend relief reduced the disparity between the tax treatment of debt and equity, it would help eliminate the current bias in favor of debt financing, leaving corporations free to choose the most economically efficient source of capital. Finally, corporate integration would remove one of the major disincentives to operating a business in corporate form.

While the benefits of an integrated system are substantial, the significant revenue loss that could result from such a change presents a serious obstacle to the adoption of such a system. It would be a mistake to reduce the tax burden on equity capital by increasing the burden on borrowed capital. As stated above, we believe the current tax treatment of debt is appropriate. Interest is a cost of doing business, and like other such costs should be deductible. Moreover, restrictions on the deductibility of interest would increase the cost of borrowed capital and create an advantage for potential foreign acquirers of U.S. corporations. Even a seemingly modest change in the cost of capital for U.S. companies could dramatically alter the ability of U.S. acquirers to compete in the international marketplace and, as a result, foreign acquisitions of U.S. companies could sharply increase.

D. Options Relating to Investment Banking Fees (Options D-1, D-2, and D-3).

The Committee has presented three options that would impose a nondeductible excise tax on investment banking fees. Option D-1 would impose an excise tax on all parties earning income in a leveraged buyout. Option D-2 is similar but would impose a punitive tax only on "excessive compensation." Finally, Option D-3 would impose a punitive tax on fee arrangements that present certain conflict of interest questions.

Even though BCC does not charge investment banking fees, it does not believe these options are appropriate. These options would penalize persons who participate in such transactions notwithstanding the substantial evidence presented to this Committee that leveraged buyouts often assist in allocating capital more efficiently. Moreover, contrary to fundamental principles of income taxation and basic fairness, they would single out a particular type of income for punitive tax treatment. The determination of what is a reasonable investment banking fee should be left to the marketplace and not established by the Internal Revenue Code. Requiring full disclosure to shareholders of the amount of such fees and potential conflicts of interest would be a more appropriate response to this issue.

E. Require Gain Recognition when a Corporation Borrows Against its Appreciated Assets and Distributes the Proceeds (Option F-3).

Option F-3 would require a corporation to recognize gain when it borrows against appreciated assets and distributes the proceeds. This proposal would be exceedingly complex to implement and represents poor tax policy. Under our present system of taxation, gain or loss generally is taxed only upon a "realization event"--i.e., the sale or exchange (or disposition) of an asset--and not simply upon its appreciation or depreciation. Arguments are made periodically in favor of a so-called "mark-to-market" system in which the mere appreciation or depreciation of an asset would be a taxable event. Such a system has never been adopted, however, at least in part because of the difficulty in valuing many assets and the burden it would impose on illiquid taxpayers.

It would be unfair to selectively apply a mark-to-market system to a limited class of corporate assets, simply because the corporation has incurred debt and made distributions to shareholders. The debt and the distributions will often be completely unrelated to the appreciation in any particular assets. Moreover, because this proposal would tax appreciation in goodwill, it could trigger taxable "gain" to a corporation even if its assets (other than goodwill) had depreciated in value. In such cases, the bank would be lending against anticipated future earnings (or because of a shareholder guarantee). The proposal would tax future profits in the year of borrowing and increase the basis of goodwill by a like amount. However, because goodwill can neither be amortized nor sold as a separate asset apart from the business, the practical effect of the proposal would be to tax the profits twice (because the basis accorded to goodwill does not give rise to an offsetting loss).

III. CONCLUSION

The Committee is to be commended for studying the impact of leveraged buyouts on the economy and the appropriate structure of the corporate tax system. I believe the testimony presented to the Committee to date indicates clearly that leveraged buyouts are not generally harmful to the economy and, if responsibly structured, have very positive effects on employment growth, capital formation, and economic efficiency. Consequently, the Committee should not target leveraged buyouts for unfavorable tax treatment. At the same time, the hearings before this Committee have demonstrated that the tax system's bias towards debt financing is troubling and should be corrected.

It is critical, however, that the Committee not fashion a "solution"--such as an arbitrary disallowance of a deduction for a portion of interest paid--that may cause more difficulties for the economy as a whole than does the problem being addressed. This is especially true in light of the fact that there is no crisis that requires immediate action.

Finally, if the Committee does decide to enact legislation, such legislation should include appropriate exceptions for relatively small, non-hostile management buyouts. Transaction size or interest thresholds are extremely important to the countless small to medium-sized companies for which leveraged acquisitions are the only practical means of effecting a succession in corporate ownership.

LAW FIRM

Hertogs Fluegel
Sieben Polk
Jones & LaVerdiere
PROFESSIONAL ASSOCIATION

909 Westview Drive
Hastings, MN 55033
(612) 437-3148
Fax # (612) 437-2732

Samuel H. Hertogs
• Donald J. Fluegel
• ◦ Michael R. Sieben
• ◦ Michael S. Polk
• Harvey N. Jones
• ◦ Richard A. LaVerdiere
Steven D. Hawn
George L. May
Thomas R. Longfellow
Leo F. Schumacher
Shawn M. Moynihan
Bernie M. Dusich
Mark J. Fellman
Michael R. Strom
John P. Sieben
Scott J. Hertogs
John D. Skinkle
James M. Hamilton
Eric A. Short

John O. Sonsteng

Of Counsel:
James M. Goetleman

• Also admitted in Wisconsin

◦ Certified as civil trial specialists by the National Board of Trial Advocacy

ST. PAUL OFFICE:

Gallery Building
Suite 409
17 W. Exchange St.
St. Paul, MN 55102
(612) 222-4146

May 25, 1989

Mr. Robert J. Leonard
Chief Counsel
Committee of Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Lennard:

We have been involved in the implementation of several Employee Stock Ownership Plans for our clients.

The majority of our clients are closely-held corporations, and are not public corporations.

When the owner(s) of a closely-held corporation reaches retirement age and none of his family members are involved in his business, a decision has to be made.

Either the owner(s) can sell his company to an outside party, or in the alternative, he can sell the company to his employees through the Employee Stock Ownership Plan.

As you can appreciate, an outside party could mean the loss of jobs for the present employees, and in fact could mean the closing down of the company where it is located. Most of the companies are located in smaller communities and are relied upon by that community for employment of its residents; income that is derived from the employees and their families employed by the company; and taxes paid by the company.

Nowadays the average employee does not own any asset other than his house and belongings and possibly vehicles for transportation.

Thus, when he retires, he must rely on social security benefits (and any nominal savings he has set aside) for his retirement.

By implementing an Employee Stock Ownership Plan for the purchase of the company by the employees, the employees then own stock in a company in which they can increase the growth in value through their work effort and productivity.

Thus, when an employee retires, he will have an asset, namely, his company stock (which he can then sell to the Trust or to the company) to supplement his retirement funds.

Thus, the anti-ESOP proposals pending before the House Ways and Means Committee, in our opinion should be vetoed, namely:

> "1. The present law rule allowing financial institutions to exclude from income 50 percent of the interest income received with respect to loans to ESOPs or to employers making loans to ESOPs, could be repealed or reduced, in order to reduce the differences in tax treatment between the use of debt and equity in corporate financings.
>
> 2. The deduction for dividends paid on employer securities held by and ESOP could be repealed, or could be repealed to the extent that the dividends are used to repay an acquisition loan. (To the extent dividends would become deductible pursuant to other options which may be considered by the Committee, however, a deduction could be allowed for these dividends.)
>
> 3. Present law rules could be modified so that an ESOP would not be treated as a qualified plan unless the ESOP was a supplemental retirement plan. Accordingly, the employer would be required to maintain another meaningful qualified plan as a means of protection for participants participating in ESOPs that are 100-percent leveraged, or are the only qualified plan maintained by the employer. As an alternative, the exposure of plan participants, in the event a company does not repay an ESOP loan, could be limited by providing that the acquisition of shares by an ESOP could not be 100-percent leveraged."

Again, we want to reiterate that we strongly feel that the above anti-ESOP proposals should be vetoed. Further, we strongly feel that an employee's ownership of his company should not be curtailed.

Yours very truly,

FOR THE FIRM:

Samuel H. Hertogs

Samuel H. Hertogs

AB:dso

INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA—UAW

OWEN F. BIEBER, PRESIDENT   BILL CASSTEVENS, SECRETARY-TREASURER

VICE PRESIDENTS
DONALD F. EPHLIN • ODESSA KOMER • MARC STEPP • STEPHEN P. YOKICH

IN REPLY REFER TO
1757 N STREET, N.W.
WASHINGTON, D.C. 20036
TELEPHONE (202) 828-8500
FAX (202) 293-3457
TELEX 710-822-1941

May 22, 1989

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

The UAW commends the Ways and Means Committee for holding additional hearings on the tax policy issues associated with corporate mergers, acquisitions, leveraged buyouts, and increases in corporate debt. We have reviewed the list of legislative options issued by the Committee in its press release of April 12, 1989. The following are our comments on those legislative options.

1. The UAW strongly supports option B-2, which has been incorporated in legislation previously introduced by Representative Coyne (H.R. 679). This legislation would require corporations to file pre-merger notifications. In addition, if a merger is expected to reduce the number of employees by more than 100, the corporations would be required to file a community impact statement detailing the number of affected workers, the reasons for the reduction in the workforce, possible alternatives, plans to minimize the impact on remaining employees and local governments, and the economic circumstances of the companies. The legislation authorizes the Federal Trade Commission to conduct an investigation into and hold hearings on the community impact statement. If the FTC finds that the proposed merger would have a substantial adverse effect on employment, the federal tax deduction for interest on indebtedness incurred to finance the merger would be disallowed.

Although we have some concerns about giving the FTC primary responsibility in this area, the UAW believes that H.R. 679 represents sound public policy. As a general rule, we believe that corporations should be required to prepare a "community impact statement" detailing the long and short-term social and economic consequences of a proposed merger or acquisition. Concerned parties should also be given an adequate period of time to review and comment on proposed transactions. In situations where a proposed merger or acquisition is determined not be in the public interest, the federal tax deduction for interest incurred to finance the transaction should be limited or denied. Because H.R. 679 would further these objectives, we enthusiastically support this legislation. We urge the Committee to include this proposal in any package of reforms which is developed by the Committee dealing with corporate takeovers.

2. The UAW also supports the various options listed under section D of the Committee's press release which would impose a variety of taxes on investment banking

fees. We believe there should be limits on the fees charged by the specialists who engineer corporate takeovers. Published reports indicate that the RJR Nabisco leveraged buyout generated nearly $1 billion in fees — $325 million in commercial bank fees, nearly $300 million in financing fees for investment banks, and over $150 million in advisory fees. Clearly the parties to corporate takeovers have a compelling economic incentive to get the deals done, regardless of whether the deals themselves are good for the economy. While corporate mergers and acquisitions may at times be necessary for valid economic reasons, they should not be an end in themselves, pursued by banks and investment firms seeking to enrich themselves on outrageous fees.

3. The UAW is also deeply concerned about the implications of any proposals on foreign competition and investment in this country. Any legislative package dealing with corporate takeovers must be structured in a way which does not provide an advantage to foreign companies. This would only aggravate our trade deficit and lead to the loss of jobs in this country. Although we do not have any preferences among the various legislative options described in section E of the Committee's April 12th press release, we believe that any legislative package developed by the Committee must address the tax treatment of foreign companies and foreign investment.

4. The UAW urges the Committee to explore in more detail various options, such as those listed in section F1 and 2 of the Committee's press release, associated with imposing a tax on certain corporate financing transactions. We believe that these types of transaction taxes would help to deter excessive speculation. If structured in an appropriate manner, they could also help to encourage long term savings. And, of course, these taxes could raise significant amounts of revenue which could be used to reduce the federal budget deficit and to address many of our pressing social needs.

For your information, attached is a copy of a statement which was previously submitted by the UAW in connection with hearings conducted by the Labor-Management Relations Subcommittee of the Committee on Education and Labor on the subject of corporate takeovers. This statement sets forth our views on the subject of corporate mergers and acquisitions in more detail.

In conclusion, the UAW continues to believe that there is a pressing need for legislation to curb various abuses associated with corporate mergers and acquisitions. We urge the Committee to develop a package of legislative reforms which incorporates the options discussed above.

Sincerely,

Dick Warden

Dick Warden
Legislative Director

DW:njk
opeiu494
Attachment
cc: Members, Committee on Ways and Means

STATEMENT OF
INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)
ON
CORPORATE TAKEOVERS, LEVERAGED BUYOUTS AND PENSION FUNDS
SUBMITTED TO THE
SUBCOMMITTEE ON LABOR-MANAGEMENT RELATIONS
OF THE
COMMITTEE ON EDUCATION AND LABOR
U.S. HOUSE OF REPRESENTATIVES

March 7, 1989

We are pleased to take this opportunity to present the views of the UAW on leveraged buyouts (LBOs) and other forms of corporate restructuring. The UAW represents 1.5 million active and retired workers, many of whom have been adversely affected by the recent explosion of this activity.

Like many other Americans, the UAW is fearful that the rapid rate of corporate restructuring and the concurrent growth in corporate debt are doing serious damage to our nation's economy. We are pleased that the issue is being investigated in detail by several committees in both the House and the Senate. We especially welcome and commend the focus of this Subcommittee on the many associated issues affecting working people, retirees and their unions. The problems created by this decade's tidal wave of corporate restructuring and the excessive, related use of debt financing, will require solutions that encompass a number of issues in addition to those affecting labor. However, several of the most serious abuses which urgently require corrective action involve inequities in the treatment of workers, retirees, and the communities in which they live.

While the most talented executives at foreign companies plan investments for the future, a growing proportion of U.S. executives have been preoccupied with corporate restructuring and deal-making, activities which produce no products and create no jobs. Even in those situations where unwelcome raids are fended off, the target companies can become so weakened financially in the process that the keys to future success, such as R & D budgets or investments in worker training, will be slashed deeply.

This situation might at least be tolerable if the corporate restructurings were on the whole beneficial to our economy. However, a growing body of evidence suggests that just the opposite is true. The Brookings Institution recently published a study[1] which traced mergers in the 1960s and early 1970s and found that, on average, they produced lower profits and decreased efficiency. Business Week was more succinct. By its count, somewhere between one-half and two-thirds of all mergers simply do not work.

The concerns about the corporate restructuring, leveraged buyout, and debt accumulation issues that will be addressed in this statement fall under three broad categories. We are very concerned, first of all, with those practices which unfairly penalize workers and retirees by disrupting existing collective bargaining relationships -- or worse -- or which treat workers and retirees less favorably than management. Other serious concerns include the financial incentives available to Wall Street which encourage seemingly out-of-control deal-making for its own sake, and the long-term problems associated with the tremendous growth in non-productive debt taken on by U.S. corporations.

I. Our first concern, and the one in which corrective solutions are most obvious and readily available, involves business practices which are currently legal but which encourage business decisions that clearly violate accepted social norms. In particular, we refer to the ability of a new corporate owner to disregard existing collective bargaining relationships and agreements, the related ability of corporations to restructure — through spin-offs, divestitures and similar mechanisms — in order to evade existing liabilities to employees and retirees, the prevalence of golden parachutes and other discriminatory severance arrangements, and the absence of a regulatory framework that would require outside corporate acquirers and incumbent management to reveal the economic and social impact of their proposed restructurings in a manner that would allow the public to weigh those consequences and fashion more appropriate alternatives.

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[1] David J. Ravenscraft and F.M. Scherer, Mergers, Sell-Offs, & Economic Efficiency, The Brookings Institution, Washington, D.C., 1987.

As the law currently stands, the treatment of the workforce when a business is sold is highly dependent on whether the sale is structured as a stock sale or an asset sale. No change in the employment relationship is deemed to flow from an ownership change involving the sale of a company's stock. Such events occur constantly, of course, not only in the minute-to-minute trading on the stock exchanges, but in the less frequent, but more noticeable, instances where companies merge through an exchange of shares. In all such situations, the existing union remains the representative of the workers and the existing collective bargaining agreement remains in effect. Of course, in some cases, the new majority owners come forth shortly after the acquisition and request changes to the contract, especially where elements of the transaction lessen the ability of the surviving company to meet its wage and benefit obligations to employees and retirees. When this happens — as it does altogether too frequently — the workers and the union can evaluate this request as they would a request from any company to open a contract.

In contrast, when the sale of a business is structured as an asset sale, the new owner generally is not considered to have "purchased" the bargaining relationship, the previous owner's liabilities to employees and retirees, nor, for that matter, the services of the workers who worked for the previous owner. Indeed, the new owner has no legal obligation to the seller's employees and retirees and is free to hire a new workforce as long as there is no discrimination based on union affiliation in the hiring process.[2] The new employer is required to recognize the existing union only if at least half of the workers hired were also employed by the former owner. In no event is the new employer legally bound by the contractual commitments made to the former owner's employees and retirees.

The basic protection available to workers and retirees in an asset sale is a successorship clause in their collective bargaining agreement. Unfortunately, successorship clauses are often held to be enforceable only against the former owner. Many times they do not create an obligation on the part of the asset purchaser to live up to promises made by the former owner to employees and retirees. Furthermore, enforcing such obligations typically involves lengthy, costly litigation.

In many corporate takeovers, the desire of management to unilaterally evade these liabilities to employees and retirees is the major factor behind structuring a purchase as an asset sale rather than a stock sale; all other aspects of the purchase are identical. The same plants, product lines, trade names, and customer lists are being purchased. Yet the option to fire entire workforces, evade long-standing collective bargaining relationships, unilaterally abrogate union contracts, and cut off retiree benefits, can become available to management simply because of the way the business is purchased.

The existence of a mechanism — in this case the asset sale — which allows buyers of companies to sever existing collective bargaining relationships and tear up negotiated agreements is clearly bad public policy. Beginning with the National Labor Relations Act of 1935, it has been the public policy of our country that the collective bargaining process is to be encouraged. Yet the absence of clear successorship legislation provides a significant incentive for buyers to structure corporate acquisitions in expressly anti-collective bargaining, anti-worker ways. It also provides a strategic advantage to potential takeover artists not available to present owners. No public policy goal or social purpose is served by advantaging corporate raiders, bust-up specialists and deal-makers over incumbent owners and managers in this way.

Nor is public policy served by allowing companies to evade their liabilities to employees and retirees — who have devoted their working lives to their employer — by other forms of corporate restructuring, such as spin-offs, divestitures and similar mechanisms. All too often, we in the UAW have witnessed once healthy companies being plundered, with the company's valuable assets being sold or spun off, one after another, until all that is left is a company which is quite literally a shell of its former self. This shell, however, alone carries the obligation of providing benefits due workers and retirees, an obligation which it often can no longer carry. The recent Allis-Chalmers bankruptcy — which commenced only after years of divestitures and spin-offs — is the best recent example of such abuses, with the end result being drastic cuts in retirement benefits for thousands of Allis-Chalmers retirees across the country.

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[2] Even when existing law is broken, enforcement is painfully slow. On April 15, 1985, 242 members of UAW Local 726 were fired on just four days' notice when the assets of their company, Elastic Stop Nut of America (ESNA), were sold by ESNA's parent company, Amerace Corporation to Harvard Industries. It took nearly two years before an administrative law judge ruled that Harvard's announced intention to operate in a "union-free environment" and refusal to hire the UAW workers violated the National Labor Relations Act.

In other areas of the law, Congress and the states have reined in these abuses, by allowing creditors and the courts to "pierce the veil" of corporate transactions, so that the parties to such transactions may not so easily evade their moral and legal responsibilities. The reforms have been made in recognition of the fact that continuity of the business enterprise, despite a change in ownership or structure, mandates protection of innocent third parties. These parties, like workers and retirees, continue to deal with the same enterprise and have legitimate expectations that ownership or other structural changes should not adversely affect long-standing relationships.

Examples of these developments exist in the areas of product liability, where a buyer who continues to manufacture the same "product line" may be liable for damages caused by products manufactured and marketed by the seller before the sale; ERISA, where the law provides that transactions to evade certain pension liabilities may be disregarded, at least for the purpose of holding parties to the transaction responsible for such liabilities;[3] environmental claims; and Uniform Commercial Code "bulk sales act" provisions. Even in labor law, purchasers who buy a business with the knowledge that unfair labor practice charges are pending are liable for remedying those pre-sale unfair labor practices.

The UAW believes that there is no valid reason to deny this kind of protection to workers and retirees in corporate restructuring situations. Specifically, the law should provide that, in an asset purchase, the buyer of an operation must recognize existing unions and must assume existing collective bargaining agreements. Moreover, the law should limit the ability of companies to evade existing liabilities to employees and retirees through mechanisms such as spin-offs and divestitures which leave only shell corporations to meet such obligations.

We also believe that severance agreements of the kind commonly referred to as "golden parachutes" fundamentally discriminate against working people when a change of ownership takes place. This practice, which not that long ago was the object of public indignation, has become so commonplace as to no longer generate headlines. However, its pervasiveness does not make it more acceptable. Plain and simple, the system allows top management to be bought off. When top managers live securely in the knowledge that they are protected no matter what the outcome, accountability disappears. Meanwhile, workers and local communiites are forced to bear the brunt of the "restructuring costs."

One solution to this problem is clear. We are not opposed to severance packages. As with any deferred compensation arrangement, however, the law should prevent top company management from skewing the plans for selfish gains. We therefore believe that "golden parachute" severance agreements should be prohibited unless they apply equitably to the entire workforce. This would reduce the penalty to workers when top managers allow personal gain to distort their decision-making and would at the same time encourage companies to provide much needed severance protection to all employees in a change of ownership situation.

The lack of dn adequate regulatory framework in change of ownership situations can also contribute to inappropriate business decisions, some of which may have an enormous impact on the workforce. The UAW has long held the position that, in a proposed change in ownership, the buyer ought to be required to prepare an "impact statement" detailing the long- and short-term social and economic consequences of the change. We also believe that, as is already the case in the railroad and airline industries, a proposed change should be accompanied by an adequate period for review and for public input from concerned parties. Public comment and review is wise social policy for all industries.

At the very least, we support as steps in the right direction proposals to expand SEC disclosure requirements for both outside acquirers and inside management. Because incumbent managers who make offers to take their publicly-owned companies private in an LBO are in an obvious conflict-of-interest position, we believe that managers should be compelled to publicly report why their business plans require an LBO and cannot be implemented while their company is publicly held. We also support proposals to lengthen the amount of time that shareholders confronted by a tender offer currently have to make up their minds. There is no compelling reason why these deals need to be completed in twenty days. Giving shareholders ninety days will help ensure that better decisions are made.

II. Our second broad area of concern deals with the motivations and sources of funds for many corporate reorganizations. In particular, we are concerned about deals financed with pension funds or spurred by tax breaks, and those which are driven by speculators', banks', and investment houses' pursuit of short-term profit with little if any longer-term benefit to the economy.

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[3] Section 4069 of the Employment Retirement Income Security Act.

The current ability to recapture pension plan assets is unfortunately often an additional incentive driving LBOs and other financial restructurings. The primary function of pension plans is to provide workers with adequate retirement income security. The law should prevent companies from ever recapturing so-called "surplus assets" from terminating pension plans. The money in pension plans represents deferred compensation to the workers. It is not the employer's money.

We support legislation to prohibit such reversions altogether. Absent a complete prohibition, we should at least move quickly to restrict the ability of corporate raiders, incumbent managements or other pension fund investors to use pension funds to finance or fight takeovers or engage in other forms of self-dealing.

We also favor limits on the fees charged by the specialists who engineer corporate takeovers. Published reports indicate that the recent RJR Nabisco LBO generated nearly $1 billion in fees — $325 million in commercial bank fees, nearly $300 million in financing fees for investment banks, and over $150 million in advisory fees. These are substantial sums of money. It is foolish to ignore the plain fact that such parties have a compelling economic compulsion to get deals done, regardless of whether the deals themselves are good for the economy.

The annual earnings of some investment companies now rival those of all but the largest manufacturing companies. Deal-makers routinely get seven figure bonuses. Valuable talent and other resources are being denied to American companies that undoubtedly can be and ultimately need to be put to better use. Corporate reshuffling may at times be necessary for valid economic reasons but it should not be an end in itself, pursued by banks and investment firms seeking to enrich themselves on outrageous fees.

Transaction taxes represent an excellent mechanism for deterring excessive speculation. A turnover tax on stock and bond sales and purchases would raise important revenues and at the same time discourage speculation. A surcharge on capital gains from short-term holdings is another avenue worth investigating.

III. Another area of concern is the enormous increase in corporate debt that has occurred during the 1980s and the potential harm it may do to the economy. Corporate debt in the U.S. has reached levels never seen before. Interest payments on debt alone now eat up 24 percent of corporate cash flow, a level more typical at the bottom of a deep recession than in the seventh year of a recovery.

A recent report issued by Salomon Brothers tallied 28 leveraged buyouts of more than $500 million each in the last four years. These 28 alone, totaling $65 billion in value, have spawned $25 billion in low-grade, high-yield junk bonds. Roughly half of the $140 billion in junk bonds issued since 1982 have gone to finance takeovers.

Treasury Secretary Brady testified before the House Ways and Means Committee that the total value of leveraged buyout transactions that took place between 1978 and 1983 was $11 billion. Since 1983, Secretary Brady reported, this total has reached $160 billion. Federal Deposit Insurance Corporation Chairman Seidman testified that LBO loans now average over 50 percent of the equity capital of at least the 10 largest multinational banks. While both the Secretary and the Chairman were cautious in concluding that the growth in debt was a problem, we have no qualms about expressing our concern over this fundamental deterioration in the financial position of many major American companies and lending institutions.

Some have suggested that the increase in corporate debt is no problem, because — despite the huge growth in debt — debt-equity ratios in the United States are still below those of many of our West German and Japanese competitors. Since companies in those countries have been able to exhibit solid growth, the argument goes, the run-up in debt held by U.S. companies should provide no impediment to growth or competitiveness. Unfortunately, this analysis sidesteps the differences in financial and political environments between countries; for example, the structural relationships between banks and corporations are much tighter in West Germany and Japan than here. More importantly, it ignores the fact that corporate debt levels have been shrinking in Japan and West Germany while, here, debt has gone through the roof.

We realize that concern over burgeoning debt levels at U.S. corporations must be tempered with the knowledge that debt has many useful functions. Debt taken on to expand or build new plants, to invest in the development of new products or new work methods is for the most part beneficial to our economy. Indeed, it is the diversion of so much credit to corporate restructuring undertaken for short-term gain which is undermining the nation's capacity to finance long-term productive investment.

The increase of corporate debt will also aggravate the harm from any future recession. The Brookings Institution recently ran a computer simulation of the effect of a recession equal in severity to the 1974-1975 recession. Their simulation estimated that the current high levels of corporate debt would force one company out of ten to seek shelter in bankruptcy. These are mind-boggling figures and should set off alarms in the heads of anyone concerned with our economic future.

Especially worrisome in this regard is the growing concentration of debt and the danger this presents to the government's ability to react to potential economic crises. While federal loan guarantees have in the past occasionally been used successfully to aid in the revival of large companies, notably Chrysler, Penn Central, and Lockheed, debt has grown to such a huge magnitude and become so concentrated that future crises may make these previous examples pale. Kohlberg, Kravis, Roberts, & Company is now majority owner of twenty large industrial companies. Should an outfit this size encounter serious financial trouble, who could come to the rescue? Would taxpayers be asked to cover the losses of a handful of speculators who made some miscalculations? Or might the survival of entire communities and hundreds of thousands of jobs be at risk because the amounts needed were just too great?

The list of highly leveraged large companies is now lengthy. We are truly in uncharted waters, able to rely only upon faith that the next recession will not result in economy-wide financial chaos. It would be wise for us to take action now to help minimize the future risk.

As Lane Kirkland summed up the situation in his testimony before the Senate Finance Committee on January 26, 1989:

> "Whether or not we crash and burn is not the question, only when and how many casualties there will be ... (We) take no pleasure in this prediction. We know the ultimate price will not be paid by the dealmakers; they will take the money and run. Rather, it is working people — whose voices cannot be heard now amid the current financial uproar — who will suffer."

We are encouraged by the recent decision of the Federal Reserve Board to lay out more specific guidelines to its bank examiners regarding loans used in "highly leveraged transactions." However, with such a high percentage of bank profits resulting from participation in these risky transactions, and given the recent experiences of commercial bank lending in the Third World and poorly regulated savings and loan activity leading to crisis, we believe that, at the very least, the new guidelines demand strong enforcement.

We would suggest that the new Administration strengthen and enforce existing antitrust regulations. The concentration of corporate resources into fewer hands ties our overall economic prosperity to the fortunes of a handful of corporations. Adding billions of dollars of unproductive corporate debt on top of this only increases our vulnerability.

Finally, it has been widely noted the tax code bears some degree of responsibility for the upsurge of corporate restructuring activity. We are appalled that purely speculative activities seem to be encouraged by the tax code. To the extent that the tax code is used to further socially redeeming goals, it should discourage short-term speculation. We are also very much concerned that these activities are leading to losses in government revenues at a time when we can ill afford it.

We have already identified some targeted tax ideas that would help curb speculation and raise important revenues. In addition, to the extent that it is possible to craft legislation which restricts the tax deductibility of speculative or excessive debt without unduly interfering with debt taken on for productive purposes, we would also gladly support that legislation.

We realize that, when amending the tax code, it is a difficult task to prevent inventive individuals and corporations from taking advantage of unforeseen loopholes or creating new instruments to avoid the intent of the amending legislation. For this reason, it will take skill and extreme care to fashion legislation restricting interest deductibility which cannot be circumvented.

In conclusion, the UAW's position on legislative action to control leveraged buyouts and other corporate restructurings can be summarized as follows:

- Legislation is needed which mandates that, in an asset purchase, the buyer of an operation must recognize existing unions and must assume existing collective bargaining agreements.

- Limitations are needed on the ability of corporations to evade liabilities to employees and retirees through mechanisms such as spin-offs and divestitures.

- There should be a prohibition on "golden parachutes" unless they apply equitably to the entire workforce.

- Expanded SEC disclosure requirements are needed for both outside acquirers and inside managers, as a first step toward a complete public policy framework regulating corporate restructurings involving "impact statements" and public review.

- Legislation is needed to prohibit companies from recapturing so-called "surplus assets" from terminating pension plans; at the very least, there should be restrictions on the use of pension funds to finance takeovers or engage in other forms of self-dealing.

- There should be limits on fees charged by specialists in corporate restructurings.

- A turnover tax should be levied on stock and bond transactions and a surcharge should be levied on capital gains from short-term holdings.

- Strict enforcement is needed of recently issued Federal Reserve Board guidelines regarding bank loans used in "highly leveraged transactions."

- Stronger enforcement of existing antitrust regulations is needed.

- Legislation is needed which would limit the tax deductibility of speculative or excessive corporate debt.

The UAW would like to thank the Subcommittee for allowing us to present our views on these important issues.

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STATEMENT
ON
LEVERAGED BUYOUTS

for submission to the
COMMITTEE ON WAYS AND MEANS
for
MERRILL LYNCH & CO., INC.
by
John E. Chapoton
Vinson & Elkins

May 26, 1989

Merrill Lynch & Co., Inc. is a world-wide diversified financial services company that provides investment, financing, insurance, real estate, and related services to individuals, institutions, corporations and governments. We welcome this opportunity to provide the Committee with our views on issues relating to leveraged buyouts (LBOs), and to comment specifically on the legislative options set out in the Committee's Press Release of April 12, 1989.

In general, Merrill Lynch believes LBOs are sound and desirable business acquisition techniques which have been beneficial to the economy. We also believe that adequate and timely disclosure of information is the best way to prevent abuses, to protect the rights of shareholders, and to ensure investor confidence in the integrity of our capital markets.

We have attached to this statement for inclusion in the hearing record a paper we recently prepared entitled "Leveraged Buyouts in Perspective." In this analysis, we examine the concerns raised about LBOs and attempt to dispel common misperceptions regarding the impact of these transactions on the economy, corporate debt, federal tax revenues, long-term investments, and investors.

Federal Income Tax Considerations

Of greatest interest to this Committee is the concern that the federal income tax system may be primarily responsible for LBOs, and that LBOs may have a significant, adverse impact on federal tax revenues. Our analysis suggests that neither concern is well-founded.

While it is true that the deductibility of interest and nondeductibility of dividends in the corporate tax system causes a tax bias against the use of new equity issues as a source of new corporate capital, this bias has been present for as long as the federal income tax system has been in place. Yet the misperception has arisen in the current debate over LBOs that this tax bias is a new development that suddenly has created LBOs, leading to an immediate, dramatic shift toward the use of corporate debt. In fact, the general, decades-long shift toward corporate debt seems to have slowed recently. Moreover, recent tax changes have in fact reduced the overall bias in the tax system toward debt finance.

Revenue Analysis

Two aspects of an LBO transaction potentially affect tax liabilities: the substitution by the LBO company of debt for equity, and the capital gains effect that the transaction produces. Based upon Merrill Lynch data on LBO activity from 1984 to the present, revenue estimates show that LBOs have produced a net increase in federal tax liabilities over the last five years. This increase is attributable almost entirely to the acceleration of capital gain taxes.

Impact of Tax Changes to Limit LBOs

The Committee Press Release lists some twenty-seven options to address tax policy issues with respect to mergers, acquisitions, leveraged buyouts, and recent increases in corporate debt. The various legislative options that have been suggested as possible responses to concerns about increased LBO activity primarily involve some form of limitation on the corporate interest deduction. In some instances these proposals are linked with partial relief from double taxation for corporate dividends.

The Corporate Interest Deduction

A restriction on the interest deduction for corporate debt would have two serious effects. First, by expanding the current double tax on equity to some forms of debt it would raise the cost of capital for corporations. The Treasury Department estimates, for example, that a 20 percent reduction in the amount of deductible interest would raise the cost of capital for U.S. corporations by more than 6 percent. This would make it more difficult for U.S. firms to compete with foreign companies domestically or abroad. Second, some corporations that would have changed ownership in an LBO transaction will not do so. This would further insulate existing management from the need to maximize productive use of the corporation's assets, a protection for professional managers that is not conducive to making our companies competitive worldwide.

Limiting the deductibility of interest on acquisition indebtedness would also provide a relative advantage to the purchase of U.S. companies by foreign entities. An interest limitation will make it difficult for a U.S. corporation to borrow against its existing assets to purchase another corporation, since it will lose the deduction for some or all of that interest. A foreign corporation or individual, however, will be able to borrow against existing foreign assets to acquire a U.S. corporation without losing the deductibility of its interest. As a result, foreign investors will have a bidding advantage over U.S. investors for a U.S. corporation.

A limitation on the deductibility of corporate interest could have several other negative effects, depending on how such a limitation is structured. If restrictions were applied only to debt incurred in acquisition activity, for example, the change could weaken stock market prices. Moreover, as a technical matter, limitations on acquisition indebtedness may prove to be little more than a trap for the unwary.

Another harmful effect from restricting the corporate interest deduction will occur if the restriction is targeted to high-yield debt, or to interest paid in excess of some specified percentage above the applicable federal rate. New businesses, small businesses, and businesses that involve a high degree of risk often must borrow at interest rates well above the prime rate until such time as they have developed a proven track record of profitability. Restrictions on the deductibility of interest will only make it more difficult for these businesses to compete against larger, more established corporations or foreign firms.

Limiting the deductibility of accrued but unpaid interest on original issue discount (OID) obligations could affect a wide variety of corporate financing transactions in addition to leveraged buyouts. We see little justification for disrupting the U.S. debt capital markets. Attempting to target such a limitation to debt issued "in transactions in which debt replaces corporate equity," as suggested in the Committee Press Release, presents severe definitional problems. A targeted approach also would introduce greater inefficiency, by limiting the ability of an existing corporation to adjust its capital structure to meet changing business needs, while applying no comparable limits on virtually identical obligations issued by a new, competing corporate enterprise.

Alternatively, subjecting the original issue discount on bona fide debt obligations held by tax-exempt entities such as pension funds to the tax on unrelated business income (or subjecting foreign holders of these obligations to tax) has no policy rationale, and would likely cause such investors to seek alternative debt instruments, possibly driving up the cost of capital to U.S. corporations and making the debt markets less efficient. Ill-founded concerns about LBO transactions in our view do not support changing the tax rules applicable to OID obligations.

Relief from Double Taxation

Because corporations are treated as taxable entities separate from their owners, corporate income payable to the owners of a corporation bears a double tax -- one paid by the corporation when the income is earned and a second paid by the shareholders when the corporation's after-tax income is distributed to them in the form of dividends. The double tax applies only to corporate income payable to *owners* of the corporation (i.e., its shareholders), and the second tax is paid only when such earnings are distributed to the shareholders. Corporate earnings used to pay interest are not subject to the corporate level tax. They are taxed only once at the individual, or debtholder, level.

Unlike most of our trading partners among the major industrialized nations, the United States provides no relief from the double taxation of corporate equity. Adopting measures to ameliorate the impact of double taxation would lower the cost of capital to U.S. corporations, enhancing their productivity and competitiveness in global markets.

It would be most unfortunate, however, to link dividend relief with cutbacks in the corporate interest deduction in the name of revenue neutrality. Combining these changes would impose disparate benefits and burdens among corporate taxpayers, and thus would run at cross purposes. Corporations with higher than average debt to equity ratios, for example, would be severely penalized. Moreover, as pointed out in recent Treasury testimony, maintaining revenue neutrality over time would be virtually impossible in light of changes in economic conditions and taxpayer behavior.

Excise Taxes on Investment Banking Fees

Among the legislative options listed in the Committee Press Release are three which would impose non-deductible excise taxes on certain fee income earned in connection with corporate restructuring activities. Presumably, these measures have been suggested to provide a deterrent to LBO activity on the erroneous premise that these transactions occur primarily to generate fees.

LBOs simply do not occur because of any fees associated with these transactions. Moreover, fees charged by financial advisors, although significant in some cases, make up a relatively minor part of the total value of any given transaction. Thus, imposing arbitrary and unfair excise taxes will not deter corporate restructuring activity.

The marketplace provides the best, and swiftest, limitation on "excessive" fees. As Treasury Secretary Brady has said, "If fees are too large, it doesn't take very long before competition comes in and drives them down."

Income from investment banking should be subject to tax at the same rates that apply to income earned in any other endeavor. As many observers have noted, imposing punitive excise taxes on investment banking fees would set a most unfortunate precedent -- any activity currently out of favor could be hit with a discriminatory tax.

Some critics have challenged fairness opinions issued by financial advisors in connection with LBO transactions on the grounds that they lack independence. Merrill Lynch supports the efforts currently being undertaken by the Congress and the regulators, in particular the Securities and Exchange Commission, to consider carefully the disclosure requirements in LBO transactions to ensure the continued protection of investors and integrity of the financial markets. The federal securities laws are designed to protect investors in these transactions by mandating the disclosure of material information. Although the current disclosure framework appears to achieve its objectives, Merrill Lynch wholeheartedly endorses continued examination of the scope of the existing rules to ensure that they address current market practices and continue to provide safeguards to investors. Perceived conflict of interest concerns with fairness opinions thus should be dealt with through the securities laws, not by imposing punitive excise taxes.

Employee Stock Ownership Plans

The Committee Press Release lists three options relating to employee stock ownership plans (ESOPs) which, if enacted, could have the effect of limiting the availability of ESOPs as a viable method of corporate finance. ESOPs, which are subject to the requirements generally applicable to other qualified employee benefit plans, offer employees the opportunity to participate as owners in their employers. To the extent that employees have a significant stake in a business enterprise, its efficiency and productivity are enhanced. We thus support retaining measures which encourage meaningful employee stock ownership through ESOPs.

Conclusion

Adopting tax legislation to limit LBO activity is not warranted, and moreover, would be harmful to the nation's economy, the U.S. financial markets, and the ability of U.S. firms to compete against foreign entities.

We concur with the conclusion reached by the Treasury Department in testimony before this Committee on May 16, 1989, that "the economic evidence currently available does not justify major steps such as limiting interest deductions." We share the Treasury view that "any solution to perceived problems associated with LBOs should not be attempted through the tax code at this time. The tax code is too blunt an instrument and there is a real danger that any cure -- particularly one that further increases the cost of capital to American corporate enterprise -- may be worse than the perceived problem."

Attachment

[ATTACHMENT OF MERRILL LYNCH & CO., INC. IS BEING RETAINED IN THE COMMITTEE FILES]

May 25, 1989

Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Mr. Chairman:

My name is Rudy Perpich and I am Governor of the State of Minnesota. I want to thank you for the opportunity to submit testimony on behalf on the State of Minnesota to the Committee on Ways and Means on the tax policy aspects of mergers and acquisitions.

Like many other states, Minnesota has had numerous experiences with corporate takeovers and their implications. Minnesota had been the situs of dozens of successful and unsuccessful takeover bids, involving companies such as Pillsbury, Dayton Hudson, Conwed, St. Paul Companies, Van Dusen, Gelco, and Scientific Computer.

Now the target is Delaware-chartered Northwest Airlines, the third-largest private employer in Minnesota, with the largest private payroll of any company in the state. Spurred on by Wall Street analysts who claim the airlines's stock is worth up to $120 a share if its assets are broken up and sold off, speculators have already pushed Northwest's stock price above the original takeover bid of $90 a share.

Thus, Minnesota is in danger of losing its direct link to the Pacific Rim countries -- a major source of trade for our state -- and our position as a hub for national and international airline travel. A well-managed airline profitably serving both consumers and stockholders is on the verge of being dismantled, encouraging its competitors to add debt and plan for short-term profits to shareholders to avoid a similar fate.

In Minnesota, we have already passed legislation and are currently studying other ways of preventing this situation and other abuses from occurring. But the reality is that hostile takeovers and highly leveraged buy-outs remain a national problem that demands a federal solution.

The real losers in the corporate takeover gave are our children and grandchildren who cannot afford to see an increasing percentage of our financial resources tied up in junk bonds and paper profits while other countries develop the technologies of tomorrow. Long-term investments in research do not provide instant gratification for speculating stockholders, but they do help secure the future well-being of our companies and our country.

As Governor of Minnesota, you have my support in passing legislation so that it is no longer acceptable for raiders to work backroom deals with corporate executives that make both parties multi-millionaires, while thousands of hard-working people lose their jobs under the guise of more efficient management. I strongly urge you and other members of Congress to end the borrow-breakup, fast-buck takeover game and get back to the business of productivity.

At this time, I would like to provide further details on what we have done to limit takeovers in Minnesota, and why we believe the federal government needs to take action.

Minnesota's takeover statute was the first takeover law upheld after the Supreme Court decision in Edgar v. Mite, which struck down an Illinois tender offer law as an unconstitutional restriction on interstate commerce. The Minnesota Takover Law was upheld as constitutional in Cardiff Acquititions, Inc. v. Hatch, in which the Eighth Circuit Court of Appeals concluded that the state purposes underlying investor protection outweighed the law's impact on interstate commerce, and the Court thus required the registration of certain corporate takeovers with the Minnesota Department of Commerce.

The Minnesota Business Corporation statutes cover several areas of corporate and individual conduct. For example, the law contains a control share acquisition statute, and anti-greenmail and anti-golden parachute provisions. The most important aspect of the Minnesota Takover Law is the control share acquisition provision, which was enacted for the purpose of furthering shareholder democracy. Under that provision, when a person or group wishes to acquire more than twenty percent of corporation's stock, that corporation has fifty-five days to arrange a stockholder meeting. At that meeting a majority of the shareholders must approve the voting rights of the stockholder owning twenty percent of the shares. Shareholder approval is also required at the thirty-three and fifty percent level. The Minnesota statute also restricts greenmail and golden parachutes during the process of a tender offer. I have asked that the issue of corporate takeovers be carefully analyzed and plan to submit further recommendations to the 1990 Minnesota Legislature.

The issue of hostile takeovers requires prompt action by Congress as well as the states. Controlling acquisitions is a fundamental issue in the marketplace. Traditionally, I have been a free market advocate. However the break-up of companies disrupts communities and families, destroys jobs, results in lost productivity, and diverts corporate resources from the important task of making this nation more competetive in the global marketplace. Some say that Congress should proceed slowly before making any decisions regarding leveraged buyouts and that we should allow the takeover phenomena to run its course. But the pace and size of leveraged buyouts and their ever-increasing upwards spiral suggests that an unexamined use of debt could end up distorting the economy.

Our current marketplace rewards the strategy of "de-equitization", a massive recapitalization of the nation's corporations with debt rather than the sale of stock. This is because debt discourages raiders. For several decades, companies obtained capital with the sale of new issues of stock. Yet in the last four years, corporate America has retired more than $300 billion in equity. Furthermore, the accumulated debt of non-financial companies, as measured by the Federal Reserve, has nearly doubled, to $8.7 trillion. This is turning companies into highly leveraged shells.

Corporate America values de-equitization for several reasons. First, equity capital generates dividends to shareholders that are taxable, while interest on debt is tax deductible. Second, borrowed money is cheaper to manage than equity capital. Third, equity markets undervalue the worth of a company's real estate and equipment because property is carried on the books at a continuously-depreciated purchase price, rather than at current market value. Thus, companies seek to sell assets and remove fixed costs from the balance sheet.

The new reliance on debt has its perils. According to Dunn & Bradstreet, bankrupt American companies defaulted on debts of $29.3 billion in 1984. The number rose to $36.23 billion in 1987. If the trend toward de-equitization continues, and debt becomes the primary vehicle for funding a significant number of corporations, the American and world economy may face a devastating credit crunch. These highly leveraged companies have yet to be tested by slow growth in the economy, where the number of bankruptcies could be staggering.

The question often asked is whether government should get involved. The answer is yes. The public must be protected when we no longer have a fair market. The arbitrageurs, raiders and junk bond artists are able to manipulate the price of stock with little risk to themselves. In effect, the worst case scenario for the market manipulator is to purchase a large share of a company's stock at a low price, send the price skyrocketing, and take a multi-million profit home after a month's "work".

We must close loopholes that encourage the multi-million dollar fast buck deal by speculators and takeover artists. Government should not be the silent partner in the breakup of companies. Uncle Sam is promoting corporate takeovers when the tax code encourages and facilitates the financing of these purchases, and, in fact, helps to pay for a large percentage of the takeover. We must get government out of the business of breakups by removing the tax deduction on debt. I support a removal of the deduction for interest payments on certain high-yield or so-called "junk bond" debt connected with a takeover.

The Committee also requested testimony on the potential impact of takeovers on specific industry segments. Hostile takeovers in the critical area of transportation and, specifically, in the airline industry are particularly troublesome. In addition to their potential impact on jobs and the community, the airline industry provides such an essential public service that many consider it a "quasi-utility."

With over 93 percent of the domestic air service market controlled by eight major carriers, the airline industry is already heavily concentrated. According to airline analysts, it is likely that a highly leveraged takeover of Northwest Airlines would lead to the eventualy dismantling of the company, thus exacerbating industry concentration. Attorney General Hubert Humphrey III has urged the Department of Transportation to promptly initiate an investigation relating to the threatened takeover of Northwest Airlines. To date, the State of Minnesota has heard no response. The resources of the Department of Transportation would be better utilized in investigating the potential anticompetitive impact of a hostile takeover of Northwest Airlines rather that debating whether Minnesota has the authority to enact legislation that might affect the company, as it has done recently.

I do want to express my strong support for legislation introduced by Congressmen Byron Dorgan and Bob Carr regulating hostile takeovers of a U.S. airlines. Addressing this troublesome issue requires a delicate balance between federal and state action. Denying the deduction for interest payments on debt used in certain hostile takovers and requiring the Secretary of Transportation to ensure that a proposed takoaver of an airline is financially sound and would not impair safe travel are actions best accomplished by Congress.

Again, thank you for the opportunity to submit testimony.

Sincerely,

Rudy Perpich

RUDY PERPICH
Governor

THE PARSONS CORPORATION *Worldwide Engineers/Constructors*

100 WEST WALNUT STREET
PASADENA, CALIFORNIA 91124
(818) 440-2000
Telex WH 675-336

May 22, 1989

Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Attention Mr. Robert J. Leonard, Chief Counsel

Subject ESOP Alternatives Discussed in the Leveraged Buy-Out News Release of April 12, 1989

Ladies and Gentlemen:

I am writing to bring to your attention some of the harmful effects that the ESOP alternatives recently presented in the Chairman's Press Release #13 would have upon wholly-owned ESOP companies.

The Parsons Corporation is 100% employee owned through an ESOP. Parsons, through its operating subsidiaries, designs and builds mass transit systems, airports, environmental improvement facilities, power plants, oil refineries and defense facilities. Approximately 7500 families depend on the Parsons group for their livelihood. We are the largest tax-paying employer in Pasadena, California, with offices in 50 cities across the country.

Over the past two decades, Congress established the principle and encouraged the creation of ESOP companies. In enacting the ESOP provisions, Congress rightfully believed that ESOP's are an effective way to improve the American economy by relieving the concentration of equity ownership and by improving productivity. Companies such as Parsons followed Congress' encouragement and spent millions of dollars and committed hundreds of millions of dollars to implement such programs. Studies show that there have been significant returns to the Government from 100% ESOP's in the form of increased tax revenues, improved productivity, and international competitiveness. Fewer retirees will be dependent on Government support programs. Studies also show that these benefits will increase dramatically over time. See studies by The National Center for Employee Ownership, among other studies.

However, if a change were to be made, I hope the Congress will recognize that wholly-owned ESOP companies have special problems and deserve special policy consideration. One hundred percent ESOP companies are free from most, if not all, of the perceived faults of leveraged buy-outs. ESOP buy-outs favor employees, not management; they encourage employment, not layoffs.

There are tremendous cash flow demands upon ESOP's in the first few years after they have acquired 100% of their employer's stock. Cash is needed to pay down the debt and to fund benefits to retiring employees and those who have suffered disabilities or severe financial hardships. Anything that reduces the cash flow available to a 100% ESOP, especially in the early years after a buy-out, makes a 100% ESOP that much less viable. A given cash flow will support only so much debt to buy only so much stock. Anything that reduces this cash flow makes it more difficult for employees to own their companies.

As we understand it, the major objective of your hearings was to consider steps which would discourage acquisitions that serve only the interests of power and greed. By their very nature, 100% ESOP buy-outs are not disruptive and should be encouraged rather than discouraged. They generate employment and productivity, and foster competitiveness. Three of our seven acquisitions rescued firms from bankruptcy and preserved employment in a number of cities. On this basis alone, companies which are 100%-owned by an ESOP should be exempted from the proposals.

CONGRESS SHOULD CONTINUE THE PARTIAL INTEREST EXCLUSION FOR MAJORITY-OWNED ESOP COMPANIES

Turning to the specific options mentioned in the news release, the partial interest exclusion has been very effective in providing funds to ESOP's to reduce their cash flow drain in the early years. So far, the loan pricing has been very aggressive and has made it possible for more companies to be ESOP-controlled than would otherwise be possible. We would not have been able to proceed with our ESOP if it had not been possible to secure a loan at favorable rates. The ESOP alternative has kept many U.S. companies from becoming foreign owned.

Some fine tuning of this provision may be warranted. One change you might consider is to eliminate prospectively the exclusion to the extent that debt, other than securities acquisition debt, is refinanced in an ESOP transaction.

If, for whatever reason, Congress decides to reduce or eliminate this exclusion, exceptions should be made for:

1. 100% ESOP-owned companies;
2. Existing loans, and refinancing of those loans (subject to current limitations); and
3. Loans to fund the buy-back of shares from retiring employees.

CONGRESS SHOULD CONTINUE THE DEDUCTION FOR DIVIDENDS PAID TO PARTICIPANTS OF A COMPANY WITH MAJORITY ESOP OWNERSHIP

Especially in the case of 100%-owned ESOP companies, it is doubtful whether elimination of the deduction for dividends would further the purpose of avoiding disruptive tender offers. ESOP tender offers are rarely, if ever, disruptive or hostile. What it clearly would do, would be to reduce the cash flow available to companies, making it much more difficult for constructive transactions to take place. The effect would be counter to the encouraging policy of the Congress, to date.

The deduction is a good financial step for the Government, as well. Over the long run, the taxable income flowing to ESOP participants is likely to be much larger than income received by employees of non-ESOP companies because of the improved productivity. Deductible dividends to participants are analogous to bonuses. If additional taxable bonuses were paid to the employees, the Company's deduction would match that compensation.

While we oppose the elimination of the deduction for dividends paid by ESOP companies, Congress should, at a minimum, continue the deduction for all 100% ESOP's and for all dividends paid on stock acquired by an ESOP before, say, June 1, 1989.

THE PROPOSAL TO REQUIRE ESOP'S TO BE SUPPLEMENTED BY ANOTHER PLAN SHOULD BE TEMPERED WITH ECONOMIC REALITY

Parsons supports the goal of giving employees diversification in the investment of their retirement assets but, at this time, we (like most new 100% ESOP's) cannot afford to do so. The economic reality is that our heavy debt burden must be taken care of before we can afford to diversify.

We are looking forward to the time when our employer securities acquisition debt is paid down to a level which makes it practical for our ESOP or other Plans to make major investments in other types of assets. At the present point in our ESOP's life, cash flow must go to pay down the ESOP debt, rather than being placed with diversified investments. Parsons also is constrained by statutory contribution limitations.

Particularly in the case of a company majority-owned by an ESOP, we do not see how a forced premature diversification of retirement resources would further the policy objective of discouraging disruptive takeovers. It would, however, disturb the delicate and careful financial planning which made a 100% ESOP attractive and viable to our employees in the first place. ESOP's actually encourage employment because contributions are limited by the wage base.

From the point of view of employees' retirement security, we feel that in the short run the large contributions being made to the ESOP more than offset the temporary risk of nondiversification. We have to temper our desires for diversification with the reality of the demands on our cash flow.

As a minimum, Congress should provide a grandfather exception to any diversification requirement as long as retirement withdrawals and debt service on (1) existing debt, (2) the refinancing of existing debt, and (3) new debt incurred to "buy out" retiring employees, are consuming the majority of contributions.

As a backdrop to the above general comments, please let me describe our (Parsons') ESOP. I believe we did it right, and for the right reasons.

We went 100% ESOP in 1984 for several good reasons:
(1) A philosophical view that a professional organization

(Legal, Medical, Engineering, Accounting) should be owned by its members, (2) a desire to provide a substantial and lasting benefit to the employees, and (3) a wish to secure the financial, operating and competitive benefits of a 100% ESOP-owned company.

We did it the way we believed the Congress intended:

- We have one class of stock -- none reserved for Management.
- We allowed no shares to be held by outside interests.
- We pass through the vote to ESOP participants on all issues previously referred to public shareholders, including the election of Directors.
- We have a small Board of Directors: two inside and five outside. The outside Directors serve as Trustees of the ESOP.
- We pay a cash dividend on all allocated shares.
- Employee accounts are 30% vested in three years; stairstepping to 100% in seven years.
- Accounts are paid in cash upon reaching retirement age. Inactive accounts may be paid at an earlier age in "hardship" cases.
- When we are financially able to do so, we will convert the vested values in inactive accounts to diversified investments which will be held in the ex-employee's name until he reaches retirement age.
- Each of six major subsidiaries has an ESOP Operating Committee of employees to administer the program in their unit. One member from each unit comprise the Corporate ESOP Policy Committee.

Parsons' ESOP was created with 24% ownership following the death of the Company's founder (Ralph M. Parsons) in 1974. It went 100% ESOP in 1984. The Company acquired seven engineering firms specializing in particular fields of service during the period 1977 thru 1988. While it has sometimes been generally alleged that such acquisitions have resulted in reduced employment, Attachment A confirms that this has not been the result within The Parsons Corporation.

Employees of many of the acquired companies having existing retirement plans were given the option at the time of acquisition to cross over all, half or none of their retirement accounts into Parsons' ESOP on the basis of current appraised values. The results are tabulated in Attachment B and summarized as follows:

- 87% of all employees exercised their election privilege.
- Of those selecting an option, 18% chose zero crossover; 10% chose 50% crossover; and 72% chose 100% crossover.
- Of all assets held in retirement accounts of the acquired companies ($39 million), 67% crossed over to the ESOP.

Taking our last year's financial results, I note that the Company contributed slightly over $64 million to our ESOP, of which $30 million was for payment on the loan principal, $18.6 million for payment of benefits for retire-ement and hardship cases, $12.7 million for interest on the loan, and $2.8 million in cash dividends ($.10/share) on all allocated shares. Our income before taxes and ESOP costs was $63 million, so we experienced a net loss of $1 million before payment of State, Federal or Foreign taxes. Obviously, raising the interest expense on our loan or denying a deduction for dividends paid, would seriously worsen the financial picture of our Company.

We continue to make scheduled progress toward repayment of the loan taken in 1984 to acquire all outstanding shares of The Parsons Corporation for allocation to employees under our ESOP Plan. See Attachment C for the record of payments and the future schedule.

Finally, a few background comments about the writer and his role in Parsons' ESOP. This statement is somewhat defensive, but responsive to criticism frequently heard that ESOP's favor top management as sponsors of the plan. Quite probably such cases do exist, but that has not been a factor in Parsons' ESOP.

Two charges have sometimes been made in such cases. First, that top management seeks to perpetuate its position in the Company. I have advised our Board of Directors of my intention to retire as Chairman and Chief Executive Officer at the next (1990) Annual Meeting of Shareholders.

Second, that the ESOP transaction may be self-serving to the financial advantage of top management. Not so in our case. I wrote myself out of the Plan from the outset (1974) and am the only employee who is not a shareholder of the Company. My salary, today, is precisely the same as it was four years before our 1984 ESOP transaction.

I personally held a considerable number of shares of Parsons' stock at the time of the 100% ESOP move in 1984 that I was required to sell to the ESOP. The entire proceeds of the sale (not just the capital gain) was donated to charitable causes.

Thank you very much for this opportunity to present the views of a 100% ESOP company on this important subject.

Very truly yours,
THE PARSONS CORPORATION

W.E. Leonhard

W. E. Leonhard
Chairman and
Chief Executive Offic[illegible]

WEL:lj
Attachments

ATTACHMENT ,

THE PARSONS CORPORATION

EMPLOYMENT HISTORY

UNITS	NUMBER OF EMPLOYEES WHEN ELIGIBLE TO PARTICIPATE IN ESOP	 CURRENT 4-89
S.I.P.	382	505
DE LEUW. CATHER	750	1,137
ENGINEERING-SCIENCE	461	888
C. T. MAIN	1.003	1.076
BARTON-ASCHMAN	246	300
HARLAND BARTHOLOMEW	133	130
STEINMAN. BOYNTON	237	253
	3,212	4,289

ATTACHMENT B

THE PARSONS CORPORATION

CROSSOVER ELECTIONS
($000)

UNITS	VALUE OF RETIRE-MENT PLANS	NUMBER-EMPLOYEE PARTICIPANTS		VALUE OF NUMBER VOTING	VOTE DISTRIBUTION			VALUE OF CROSS-OVER
		EXISTING PLANS	VOTING		0%	50%	100%	
S.I.P.	$7,037	382	321	$6,411	40	26	255	$5,449
DE LEUW, CATHER	10,267	750	581	10,164	209	78	294	5,500
ENGINEERING-SCIENCE	2,716	203	193	2,662	32	13	148	2,144
BRIAN WATT ASSOC.	213	30	29	211	3	5	21	162
C. T. MAIN	18,900	1,003	943	17,767	97	72	774	12,969
	$39,133	2,368	2,067	$37,215	381	194	1,492	$26,224

THE PARSONS CORPORATION ATTACHMENT C

QUALIFIED SECURITIES ACQUISITION DEBT

(000)

	TERM LOAN
DECEMBER 1984	$300.000
BALANCE DECEMBER 28. 1984	300.000
REPAID 1985	(30,000)
BALANCE DECEMBER 27. 1985	270,000
REPAID 1986	(60.000)
BALANCE DECEMBER 26. 1986	210.000
REPAID 1987	(30.000)
BALANCE DECEMBER 25. 1987	180.000
REPAID 1988	(30.000)
BALANCE DECEMBER 30. 1988	150.000
DUE SEPTEMBER 15. 1989	(30.000)
BALANCE SEPTEMBER 15. 1989	$120.000

BALANCE PAYABLE $30 MILLION PER YEAR 1990-1993.

plant
closures
project

May 25, 1989

Testimony Submitted to:
Honorable Dan Rostenkowski (D., Ill.), Chairman
Committee on Ways and Means, U.S. House of Representatives
Hearings on Tax Policy Aspects of Mergers and Acquisitions

Testimony Submitted by:
Leanna Noble, Project Organizer
Plant Closures Project
433 Jefferson, Oakland, CA 94607
415-834-5656

Honorable Chairman and Committee Members:

This written testimony is respectfully submitted on behalf of the hundreds of members of the Plant Closures Project as well as the 650 laid-off Safeway workers formerly employed at the Safeway Richmond, CA warehouse. Testimony will address options before the Committee as well as provide information on the devastating impact of mergers and acquisitions on workers, their families and the local economy.

Following are comments on specific options under consideration by the Committee:

1. Recommend adoption of option modifying current tax treatment of corporate interest:
    a) denial of deduction for interest for debt incurred to finance mergers, specifically transactions that result in significant loss of jobs (H.R. 679)
2. Recommend adoption of options relating to investment banking fees:
    a) imposition of nondeductible excise tax on compensation derived by any party earning income in a leveraged buyout
    b) assessment of nondeductible excise tax on excessive compensation derived by individuals from services rendered in connection with merger and acquisition activity
    c) assessment of nondeductible excise tax on so-called "two-tiered" rate structueres for advisory fees based upon the success of an offer as well as assessment of nondeductible excise tax upon financial advisors both providing an independent appraisal of target company's assets and playing a role in tender offer for same company
3. Recommend adoption of regulations and regulatory bodies/process to formally include significant advance notice to unions, workers, communities and local governments impacted by potential mergers and acquisitions including but not limited to:
    a) provision of all relevant financial records, information and projections
    b) provision of names, addresses and phone numbers for all key financial actors and advisors
    c) provision of projected figures on direct and indirect job loss, wages and benefits
    d) provision of projected figures on local, state and federal tax revenues impact
4. Recommend adoption of regulatory and enforcement process which formally includes representatives from labor and community groups as well as local elected officials.

433 jefferson, oakland, ca 94607 (415) 834-5656

For ten (10) months now, since July 1989, 650 laid-off Safeway workers and more than 200 religious, community, union and elected officials have been battling with Safeway to save the jobs of these laid-off workers. In July 1988 a spectacular fire destroyed much of Safeway's Richmond warehouse. Literally overnight 650 workers and their families lost their income. The "ripple effect" on the West Contra Costa County local economy has been significant -- to the extent that the Richmond Chamber of Commerce is a member of the Honest Deal Coalition which coordinates the efforts of the more than 200 leaders and groups advocating jobs for the displaced Safeway workers.

The past ten months of effort convinces our organization that Safeway's delay in resolving the future of these 650 workers and our local economy is a part of the devastating legacy of KKR's leveraged buyout of Safeway in 1985. The price being paid by these workers, their families and our local economy contrasts greatly with the record-breaking annual income of Safeway's President Peter Magowan and the record-breaking fees and profit reaped by KKR.

Our organization must rely on our direct experience in pressuring Safeway publically and at the negotiating table. We cannot rely on direct factual information because there are no legal requirements that either Safeway or KKR provide Teamsters Local 315 (union representing the laid-off workers), local elected officials or the community with financial information, projections, plans, etc. The past 10 months are clear indication that the workers and their union as well as local government cannot rely on any voluntary sense of corporate responsiblity. We must have regulations and enforcement procedures which require provision of information to impacted parties and establish the legitimate proactive decision-making and planning role for labor and community in such vital matters.

There are several indicators that the KKR leveraged boyout of Safeway in 1985 has cost our community quality, good-paying jobs and has had a similarly devastating impact on other communities. Safeway's 1985 Securities and Exchange Commission Form 10-K lists 164,385 full and part-time employees. Safeway's 1988 (covering Fiscal Year 1987) 10-K lists 130,922 full and part-time employees. This is a loss of 33,463 jobs according to Safeway's official reporting. A list of Safeway closures and lay-offs compiled by the Data Center (relying on news clippings) documents more than 14,600 Safeway jobs lost between 8/86 and 7/88 nation-wide. More than 3,500 Safeway workers in New Mexico, Colorado, Kansas and Arkansas have been blackmailed by Safeway/KKR at the contract negotiating table with the real threat of closures and layoffs as Safeway and KKR have proceeded to re-structure their corporate debt at the expense of thousands of workers and their families and our local economies.

Since July 1988 Safeway has avoided re-building the burned Richmond warehouse and re-hiring the 650 laid-off workers by contracting-out their warehouse and trucking work. This arrangement has denied laid-off workers full-time jobs with comparable wages and benefits. Our research shows that only 9 laid-off truck drivers have gotten work under Safeway's current contracting-out scheme. Only 1/3 of the orginally laid-off Safeway workers have retired early or taken the severance package negotiated by their union. Although there is a well-coordinated Private Industry Council job counseling and placement program available to this group of workers, less than 100 have found new jobs. Less than one-half of these newly hired workers are working full-time. None of them are receiving wages comparable to their Safeway earnings. THESE WORKERS WANT THEIR SAFEWAY JOBS BACK! The reasons are obvious.

We are convinced that a major factor in this unacceptable example of corporate greed is the KKR leveraged buyout of Safeway and the resulting pressures to retire corporate debt while paying outrageous management incentives and salaries plus KKR fees and profits.

We reiterate our strong support for previously listed regulatory and enforcement options. The well-being of our communities and economy must be protected. We look to you, our elected officials, for leadership in this matter.

Attachments: Safeway Plant Shutdowns Directory Listing
Labor Center Reporter
Honest Deal Coalition Fact Sheet
Honest Deal Coalition Endorsers List
Honest Deal Coalition Up-date Mailing
Plant Closures Fact Sheet

05/12/89

SAFEWAY PLANT SHUTDOWNS DIRECTORY
1983 THROUGH 1988
DataCenter, 464 19th Street, Oakland CA 94612
415/835-4692

s=shutdown l=layoff

COMPANY	DATE	LOCATION	INDUSTRY	WORKERS AFFECTED	TYPE	NOTES
Safeway	11/83	Washington, DC	grocery store	n.a.	s	May sell to independent grocer.
Safeway	06/84	Sacramento, CA	supermarket	4,400	s	Threatened shutdown if 76 stores continue to be "unprofitable."
Safeway	07/85	Antioch, CA	food, retail	50-100	s	Permanent closure of 16 year old store
Safeway	08/85	Moraga, CA	food, retail	n.a.	s	Inevitable closing since opening of nearby SuperSafeway
Safeway	08/86	Oakland, CA	retail, food	300	l	25% cut in administrative jobs as part of planned reduction in costs
Safeway	09/86	Oakland, CA	retail, food	3000	l	Layoffs of as many as 3000 non-union workers in anticipation of company's sale
Safeway	10/86	Walnut Creek, CA	retail, food	15	l	Additional cuts at its supply division, second wave cuts following LBO
Safeway	11/86	Washington, DC	retail, food	186	s	Announced plans to close six area stores by end of year
Safeway	12/86	Washington, DC	retail, food	n.a.	s	Close store despite local law requiring it to be kept open 90 days
Safeway	02/87	CA	retail, food	800	s	22 stores in S CA put up for sale and will be closed if sold
Safeway	02/87	MD DE	retail, food	525	s	Safeway closed stores after union rejected concessionary demands
Safeway	04/87	Dallas, TX	retail, food	8500	s	Oakland-based company to close 141-store Dallas division
Safeway	04/87	Richmond, VA	retail, food	420	s	Plans to close area distribution center
Safeway	09/87	Washington, DC	retail, food	30	s	Shutdown of food store with promise that all employees to be relocated
Safeway	09/87	VA	retail, food	120	s	Resulting from previously sale of Richmond offices and warehouses
Safeway	04/88	Oakland, CA	supermarkets	70	l	Cutting 10% of headquarter staff to concentrate resources on retail operations
Safeway	07/88	Richmond, CA	food warehouse	500	l	Warehouse staff and truckers cut after massive fire at regional distribtn center

LABOR CENTER
Reporter
April 1989
Number 263

THE BURNING OF RICHMOND

By *Marty Morgenstern*

Local 315 of the International Brotherhood of Teamsters, Chauffeurs and Warehousemen, AFL-CIO, is located in Martinez, California and has about 3,000 members. But not for long. Over a third of the members are, or were, employed at the Safeway warehouse facility in neighboring Richmond, California. Most of the warehousers liked working in Richmond, a San Francisco-Bay Area working class city with a large minority population, and most regard the $11 to $16 an hour they earn at Safeway as good pay. Local 315 leaders believe that their contract is perhaps the best Teamster-Safeway contract in the nation: good health and welfare benefits, job protections and work rules. Turnover is low—most workers at the facility have been there for over 12 years, many over 20. But all that is changing, and not for the better, at least not from the workers' or the community's viewpoint.

On July 11, 1988, a fire destroyed about half of the Richmond warehouse facility. At first, Ysidro Madrigal, a 56-year-old Safeway worker with 18 years on the job, was not alarmed. "I thought it was a matter of days," he said, "the company would rent another warehouse and we'd be back to work. I never thought they would leave us without a job." If most of the employees shared this attitude, they received a rude and rapid awakening. On July 12, 1988, just one day after the fire, Safeway sent the following letter to about 650 of their people. They didn't waste words.

> *Dear Grocery Warehouse Employee:*
>
> *Pursuant to the provisions of the Collective Bargaining Agreement, you are hereby given notice that you are layed* [sic] *off from Safeway Stores, Inc. effective immediately until further notice.*
>
> *Sincerely,*
>
> *Safeway Stores, Inc.*

Soon thereafter, all those who received the letter were called in by Safeway for a status report. They didn't get much news, but their electronic gate passes were collected. "They were afraid we might try to come back to work," said Ysidro with a forced smile. In fact, eight months later, few have received any "further notice," at least 550 warehouse workers and drivers, including Ysidro despite his 18 years of seniority, remain laid-off.

On January 21, 1989, Safeway announced that it would not rebuild in Richmond; they plan to take their business elsewhere. This not only leaves the workers now on lay-off permanently burned out of a job, it means that the six hundred plus employees still working in the undamaged buildings also face displacement as soon as Safeway relocates. (One day before announcing their plan to abandon Richmond, the company made a conditional land purchase in the rural Central Valley city of Tracy.)

Who Loses?

The workers are not the only losers. The city of Richmond has a high unemployment rate and one of the lowest per capita income levels, and lowest tax bases, in the Bay Area. The city has more than its share of slums, ghettos and minorities who need help. Marilyn Moore of Turn On to America, an all volunteer organization that distributes thousands of pounds of donated food to people in places they have identified as the county's neediest, says that Richmond locations have always been at the top of their list. The city now faces a worsening of its problems as Safeway moves to greener central valley pastures.

Richmond Mayor George Livingston says he does not really know why Safeway pulled up stakes. "They were not the best citizens . . . they were like the guys who live next door and

Institute of Industrial Relations 2521 Channing Way, Rm. 300, Berkeley, CA 94720 (415) 642-0323
University of California at Berkeley

refuse to talk to you. They weren't losing money; we've seen the balance sheets." The mayor says that the city's large Black population guarantees that its unemployment rate will be worse than in places where the citizens do not have to deal with racism. He said that while efforts are being made for those out of work, the city and many of the workers who live there will suffer from Safeway's unexplained retreat from Richmond.

Local 315 stands to lose a third of its members and as a result, the local will have to reduce its staff. The loss of members and staff, and perhaps most importantly, the reason underlying the Safeway decision not to rebuild in Richmond—a negative attitude toward trucking and warehousing in the East Bay Area—will hurt the morale of the entire membership. For the national union, the IBT, another loss of members in its basic industry, to add to the many thousands of truckers and warehousemen it has lost since the trucking industry was deregulated, is not a happy event.

Safeway counts itself as a loser too. In a highly competitive industry, the ability to stock stores quickly and efficiently can cost business and—especially with $4.2 billion in debt as a result of a leveraged buy-out in 1986—loss of business is not what the supermarket chain needs. But for Safeway, unlike the other parties here, relief appears close at hand.

They have managed to keep their stores adequately stocked, in part by requiring 15-hour days from drivers working out of the remaining Richmond buildings, and nearby warehouses in Sacramento and Fremont. (An anonymous Safeway executive allowed that it was possible that some workers put in 15-hour shifts, though regulations permit "only" 10 hours actually behind the wheel. He doubted this was happening often, but he wasn't sure.) The burned properties were fully insured and the Richmond land is worth about $245,000 an acre, more than five times the cost in Tracy. Thus the relocation, if the company does indeed build elsewhere, will not only be cost-free, there should be a little left over to add to the $44 million operating profit that Safeway is currently reporting.

The Union Fights Back

"Safeway has never given us a thing without a fight, why should they start now?" The speaker is Ron Teninty, President of Local 315. He is talking to the 50 former Richmond warehousers who showed up at their weekly support meeting one recent Thursday evening. He is reporting on the union's efforts to guarantee them seniority hiring rights in the warehouses that are expected to replace Richmond in the Safeway supply network; existing facilities in Sacramento and Fremont, and the probable new location in Tracy. Ron's words are in response to a skeptical member who is wary of Safeway's intentions for the fire victims.

The right to follow the work to a new facility—extended call-back and transfer rights—is the major issue now being negotiated, but others are on the table. The major demand of the union, rebuilding in Richmond, has already been ruled out by the company, but a number of grievances remain unsettled. The union has already won one week of severance pay for every year of work, but it is pushing hard to have a February 1, 1989 deadline for accepting severance reopened and extended until the workers have more information about their prospects for transfer.

The union also suspects that in moving the work around, Safeway will try to play each group of workers off against those in the other locations. To prevent this, and to generally improve the union's bargaining position, the Western Council of Teamsters has stepped into the negotiations with the intention of writing one master contract for all Northern California warehouses. Three local unions—439 in Fremont and 150 in Sacramento, along with 315—have seats on the negotiating committee.

Ron Teninty says that Safeway is acting as it always does, it is dealing with the union, but hanging tough on every issue—holding back on every grievance, big or little, to maintain maximum leverage for trade-offs. When Teninty talks about Safeway operates, it makes sense to listen up. He worked in the Richmond warehouse for 12 years and during that time served as a teamster shop steward. He was the business agent for eight more years before taking over as local president in 1987. Along the way he went through the labor studies program at Merritt College and then completed the leadership training program here at the U.C. Berkeley Labor Center.

The Laid-Off Workers

The union surveyed the laid-off workers and came up with the following statistics. They are 88% male and 54% minority (Black, 18%; Hispanic, 26%; American Indian, 4%; Asian, 4%). Seventy percent are currently married and 47% are over age 40. Most, 84%, attended high school; 23% went to college, with 8% getting an undergraduate degree. Thirty-four percent either accepted severance pay (8%), retired (11%) or got a transfer (15%), thus 66% still want their jobs back.

Ron Rhone, Darlene Ward, Syd Hadsell and Ysidro Madrigal are former warehousers who now work for the Richmond Private Industry Council (PIC), an organization that receives federal and state funds to assist laid-off workers with counseling, skill training and job placements. Probably not by sheer coincidence, they constitute a representative cross-section of the displaced workforce. Darlene, white and the sole woman in this group, has 13 years of Safeway service. Ron, a Black, Ysidro, a Latino, and Syd, also white, have two, 15 and 10 years of seniority, respectively.

They got their temporary jobs because Local 315 recognized that the Richmond crisis required a response beyond traditional union tactics. The leadership moved quickly into the political arena to secure strong city council support for the laid-off workers. The task of the Teamsters at PIC is to encourage their fellow employees to use the available services, and they have so far assisted about 250 Safeway workers who have registered with the PIC or dropped by without actually signing up for service. The groups also serves as a rallying point for community action in support of all the warehouse workers, those already on lay-off and those who still have the loss of their job to look forward to.

Spend some time at the Richmond PIC and the problems of displaced workers come across in human terms. On the morning they were interviewed for this article, one of the Safeway Four was called out to see a client. It was a man whose wife had cancer. The three to four months of extended health insurance payments that Local 315 had squeezed out of Safeway had, of course, long since expired. Under the recent COBRA amendments to federal law, he is guaranteed the right to continue his health insurance coverage, but at his own expense. However, as he is still out of work, he can't afford the $333 monthly premium. Yet without health insurance, his wife can't afford to live.

Several of the people who have sought help have faced foreclosure on their houses. By hook or crook, some have been bailed out. One foreclosure was recently avoided until a buyer could be found, and something salvaged for the family. Others were less lucky, at least a few homes have been lost.

Many of the workers who come in have yet to find new jobs, others are working. Three are now doing maintenance work for the Richmond Unified School District. As new, probationary workers, they are lucky to make half what an experienced warehouser earns. Starting over hurts, but at least they have a paycheck and health benefits. Most of those who have gone to non-union service jobs, or throwing paper routes, have even less in pay and nothing in benefits. PIC directs many people to food and pantry banks, and to the Volunteers Turn On America, which provided food, clothing and Christmas trees to many.

Darlene Ward, the woman at PIC, has what the company likes to call a Safeway romance. She met her husband, Charley, at work, and five years ago they got married. Like four or five other couples in the same situation, first they worked together, then they got laid-off together. Though Charley is an experienced worker with many skills and 23 years of seniority at the warehouse, he still hasn't found steady work. With the relocation and transfer issues unsettled, many employers, including Safeway store managers, are reported to be reluctant to hire and train anyone who might be called back to their former job.

Still Darlene considers herself lucky, her kids are grown: "If this had come when I was a single mother, it would have been worse. One thing about this [the warehouse] job, a single worker can get by and raise a family. It's like non-union, you have something. When you get laid of you try to hang onto what you have, but you can't. When you get down to nothing, lose the house and everything, they you can get Section 8 housing and food stamps and stay alive on $5 an hour. It's a slow steady fall downhill, but its much worse for the ones with little children or putting kids through school." The Plant Closure Project, another organization working with the laid-off workers, says 70% of them have families to support.

The Plant Closure Project

In response to basic industry closures throughout the nation, and taking special inspiration from the involvement of the religious community in the Youngstown Steel struggle, the Plant Closure Project of Oakland was formed in 1981. Located in the Catholic Charities building, it gets support from church groups, labor (all nine Bay Area Central Labor bodies), community members, several foundations and many local elected officials. The Project opposes closures, large lay-offs and the contracting out of public sector jobs and services. It sponsors or supports "fight back" campaigns—like the one being conducted in Richmond—and worker protection legislation, and it engages in efforts to educate the public on the impact of job threatening actions by industry.

Syd Hadsell of PIC said of his clients that "few if any are doing as well as before the lay-off." Leanna Noble of Plant Closures supplies Bureau of labor Statistics figures that supports this conclusion on a national basis. A 1985 survey of 5.1 million workers laid off in the early 1980s shows one-third were still unemployed. Of the two-thirds (3.4 million) working, 44% took a pay cut and an astonishing 60% did not have health insurance coverage in their new jobs.

An Honest Deal

Armed with these facts and many more, and prepared in 18 years of community organizing efforts, Noble helped Local 315 and community groups organize The Honest Deal Coalition. This remarkable broad-based group is putting pressure on Safeway to deal fairly with all of the victims of the fire, including the many city residents who suffered property damage or illness. They have held countless meetings in churches, union halls and public auditoriums, and sponsored a demonstration that brought out the Mayor, most of the city council and hundreds of concerned citizens. Currently, the coalition is running a massive letter writing and phone calling effort designed to besiege Safeway officials with evidence of community support for the demands of the union and local residents.

The Plant Closure Project points out that mass lay-offs can have devastating results. Not just job, pension and benefits go. Workers also suffer physical and emotional stress that can result in family break-up, neglected or abused children, and an increase in illness, drug abuse and crime. There is hardly an end to the pain that can accompany job loss in our society. And when the lost jobs are concentrated in one area, many small local businesses—restaurants, pharmacies, cleaners, bank branches—suffer and may even close. Schools lose their tax base, some of the community's oldest and most solid members are forced to move. Economists estimate that for every inside job lost when a large plant closes, three to four other jobs in the surrounding community are also abolished.

Why the Move

Why is Safeway management doing this to Richmond and its employees? They say the land will be cheaper and more plentiful in Tracy (or elsewhere in the Central Valley) and traffic problems fewer, all of which is probably quite true. They find these advantages outweigh the downsides of the move. Yet two years ago, when managers were themselves faced with lay-off in the form of a hostile takeover, they were motivated to move mountains to avert such an eventuality. They called upon the investment syndicate of Kohlberg, Kravits and Roberts (KKR) and these operators came quickly to management's rescue. In a friendly leveraged buy-out (LBO), they awarded the hostile Dart Company $150 million in greenmail (to get them to back-off), paid $10 million to their lawyers and took $60 million—and control of the company—for their own efforts.

All this required $4.2 billion in new debt (in a leveraged buyout, one borrows money, at high interest, by putting the purchased company up as collateral). To reduce this debt, a thousand stores were sold off, and with the stores, 30,000 store employees went out the corporate door. (This according to Jim Hightower in the *New York Times*, 6/21/87, but the Teamsters say that when distribution workers are considered, the number of Safeway workers displaced is closer to 40,000.) Though their operation is now smaller, Safeway hasn't reported the loss of a single vice president, nor were wages at the top diminished.

A call to Safeway's executive offices in Oakland resulted in a conversation with an executive who asked to remain anonymous because "I'm not supposed to talk to anyone, but I don't want people to get a totally wrong picture." He doubted that 30,000 (no less 40,000) lay-offs resulted from the LBO, but acknowledged that "We did get rid of many jobs, the figure was high but I doubt it was that high." He said that the people were probably working for the new store owners, but acknowledged that this was speculation because it was not a condition of many sales, and that even where it was, the workers probably lost union representation rights, and even more probably, they took pay cuts also. As for any Safeway responsibility to the warehousers, he said that the company can't pay people when it has nothing for them to do and "We've negotiated the most generous severance package we've ever negotiated."

The Safeway executive acknowledged that the company had an operating profit, but not necessarily a profit after debt service. He justified the lay-offs and divestitures as needed to pay off the new loans, an argument that has lead many, but apparently not Safeway management, to question the wisdom of LBOs and the debt they necessarily generate.

No matter whose facts or logic one accepts, the Safeway figures pale before KKR's most recent venture, the $24.88 billion takeover of RJR Nabisco. According to the noted Harvard scholar Robert B. Reich, this deal generated a cool $1 billion in fees. Professor Reich also tells us that the two principal partners of KKR, Henry R. Kravits and George R. Roberts, each earn about $70 million a year. To put this number, 70 million, into perspective, consider that the maximum total payroll cost for all 1,200 workers who at one time worked at the warehouse (this assumes that all of the workers are or were at the top of the warehouse pay scales, and that the cost of employee benefits and payroll taxes at Safeway is a high 50% of pay) would only be $60 million—$10 million less than either KKR partner earns himself!

The workers know that Safeway has the right—from a strictly legal point of view—to move or sell off its properties, even if it means selling out the employees and communities that made the company and its managers rich. They argue, simply, that workers should have rights too, and that if the company insists on taking actions that harm them and their communities, it is reasonable and socially responsible to require the company to pay fair compensation to all the injured parties.

Safeway's employees say they are not looking for a handout. Rather, just as the people in the old Safeway ads, they feel they worked an honest day, and they, too, deserve an honest deal. The workers wonder why the company no longer uses that slogan—or follows that policy?

For more information about the efforts to assist the laid-off warehouse workers, one can call Leanna Noble at the Plant Closures Project, (415) 834-5656 or Ron Teninty at IBT Local 315, 228-2246.

This article does not necessarily represent the opinion of the Center for Labor Research and Education, the Institute of Industrial Relations, or the University of California. The author is solely responsible for its contents. Labor organizations and their press associates are encouraged to reproduce any LCR articles for further distribution.

plant
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HONEST DEAL COALITION

The Plant Closures Project and Teamsters Local 315 are organizing an "Honest Deal Coalition" of Safeway workers, churches, community groups, unions, small businesses and elected officials with the following goals:

1. Win workers extended severance deadline because of Safeways delays.
2. Win extended call-back rights and transfer rights.
3. Win workers & community inclusion NOW in Safeway/KKR decision-making that impacts our lives.
4. Win job opportunities & assistance for laid-off employees.
5. Win fair compensation for neighborhood residents who suffer illness and damages caused by the fire.

LISTED BELOW ARE SOME FACTS RELATED TO THE EFFECTS OF THE FIRE.

1. 650 Safeway employees lost their jobs.
2. 50% of the workers are 40 years old or older.
3. 15% are women.
4. 57% are ethnic minorities.
5. 70% have families to support.
6. 45% live in West Contra Costa County.
7. 20% live in Alameda County.
8. Approx. 1550 family members affected.
9. Possibility of loss of homes, bankruptcy & becoming homeless.
10. Emotional impact on individuals causes: physical, emotional & substance abuse; loss of family unit by divorce or separation; children's educational & emotional needs are left unfilled; there's depression, illness, extreme stress and possible suicides.
11. Loss of pensions, health & other benefits.
12. Over 35,000 claims for property and personal damages submitted.
13. The local tax base is decreased.
14. The community in general suffers ie: unemployment rises dramatically; social services become over-burdened; loss of revenues for banks, drugstores, restaurants & most small businesses, and also for schools.
15. More than 90,000 Bay Area workers lost jobs since 1980 due to Plant Closures.
16. An average of only 50% of workers hit by plant closures find any new job, and those finding jobs earn only 2/3 of former wages.
17. An additional 3 to 6 jobs are lost for every direct plant closure job lost due to "ripple effect".

WHAT YOUR GROUP CAN DO:

1. Become Honest Deal Coalition endorsers as individual or group.
2. Raise consciousness with forums.
3. Send letter to Peter Magowan & other Safeway officials.
4. Follow up with a delegation from your group.
5. Send "Letters to the Editor".

Donations Welcome! Please make checks payable to Plant Closures Project (designated H.D.C.). For more information please contact Plant Closures Project at:

433 jefferson, oakland, ca 94607 (415) 834-5656

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02/27/89

HONEST DEAL COALITION ENDORSERS

Religious Leaders

Rev. Patrick Bishop, St. Joseph's Church of Pinole
Rev. Edward Casey, St. Callistus Church of El Sobrante
Center for Ethics and Social Policy
Rev. George Crespin, Chancellor of the Diocese of Oakland
Rev. Kenneth Davis, St. Paul Catholic Church of San Pablo
Rev. Eugene Farlough, Sojourner Truth Presbyterian Church of Richmond
Rev. John Foley, Court United Methodist Church of Alameda
Rev. Frederick Gray, Elmhurst United Methodist Church of Oakland
Fr. Edgar Haasl, St. Louis Bertrand Catholic Church of Oakland
Rev. Jesse Jackson, Operation Push and Rainbow Coalition
Fr. Daniel Kane, St. Mark's Catholic Church of Richmond
Ysidro Madrigal, Deacon St. Paul Catholic Church of San Pablo
Fr. Matthews, St. Cornelius Catholic Church
Methodist Federation for Social Action
Ministers for the People of West Oakland
Rev. John Moyer, Executive Director of Northern California Ecumenical Council
Northern California Interfaith Council for Economic Justice and Work
Rev. Bill O'Donnell, St. Joseph the Workman Church of Berkeley
Rev. Allen Ramirez, St. Paul Catholic Church of San Pablo
St. Anne's Catholic Church of Union City
Rev. Ron Swisher, Easter Hill United Mehtodist Church of Richmond
Dr. J. Alfred Smith, Sr., Allen Temple Baptist Church
Rev. Lee Williamson, Melrose United Methodist Church of Oakland

Labor Organizations

AFSCME Local 444
AFSCME Local 2700
AFSCME Council 10 Local 3211
Alameda County Building & Construction Trades Council, AFL-CIO
Alameda County Central Labor Council, AFL-CIO
Amalgamated Transit Union Local 192
Automobile Salesmen's Union Local 1095
Bakery, Confectionery & Tobacco Workers Local 119
Bay Area Typographical Union Local 21
California State Federation of Labor, AFL-CIO
Contra Costa County Building Trades Council, AFL-CIO
Contra Costa County Central Labor Council, AFL-CIO
Mike Day, IAM District Council 190
East Bay Coalition of Labor Union Women, CLUW
Elevator Constructors
Engineers & Scientists of CA., MEBA (AFL_CIO)
Firefighters Local 188
Firefighters Local 55

(more)

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Firefighters Local 798
Furniture Workers Local 262
IAMachinists Local 284
IAMachinists Local 781
IAMachinists Local 1173
IAMachinists Local 1781
IAMachinists and Aerospace Workers Local 284
Int'l Brotherhood of Teamsters Joint Council 7
Int'l Brotherhood of Teamsters Local 70
Int'l Brotherhood of Teamsters Local 162
Int'l Brotherhood of Teamsters Local 166
Int'l Brotherhood of Teamsters Local 174
Int'l Brotherhood of Teamsters Local 206
Int'l Brotherhood of Teamsters Local 228
Int'l Brotherhood of Teamsters Local 287 (San Jose)
Int'l Brotherhood of Teamsters Local 302
Int'l Brotherhood of Teamsters Local 315
Int'l Brotherhood of Teamsters Local 350
Int'l Brotherhood of Teamsters Local 381
Int'l Brotherhood of Teamsters Local 435
Int'l Brotherhood of Teamsters Local 439
Int'l Brotherhood of Teamsters Local 517
Int'l Brotherhood of Teamsters Local 542
Int'l Brotherhood of Teamsters Local 588
Int'l Brotherhood of Teamsters Local 665
Int'l Brotherhood of Teamsters Local 748
Int'l Brotherhood of Teamsters Local 853
Int'l Brotherhood of Teamsters Local 896
Laborers Local 324
Marin County Central Labor Council
Moving Picture Local 162
Napa-Solano Counties Central Labor Council, AFL-CIO
NALC Local 1111
Operating Engineers Local 3
Painters Local 741
Plumbers Local 38
Plumbers Local 159
Retirees Club Local 315
Roofers Union Local 81
San Francisco Labor Council
San Francisco Chapter Coalition of Labor Union Women, CLUW
San Francisco Federation of Teachers Local 61
San Mateo County Central Labor Council
SEIU Local 535
SEIU Local 616
SEIU Local 790
SEIU Local 790, Richmond Chapter
Ship Clerks' Association, ILWU Local 34
Sonoma-Mendocino-Lake Counties Building Trades Council, AFL-CIO
Theatrical Stage Employees Local 16
Theatrical Federation of San Francisco
UFCW Local 115
UFCW Local 532
UFCW Local 1179
And more than 11 additional Teamster Locals from 8 other cities in California and 3 other states

(more)

Community Groups

Affirmative Action/Human Relations Commission of Richmond
AFL-CIO Community Services, Contra Costa County
Bobbi Arnold, Richmond Community Activist
Rick Aubry, Mental Health Administrator Contra Costa County
Berkeley-Oakland Rainbow Coalition (8th C.D.)
Black Americans Political Association of California
Betty Boatmun, Executive Director YWCA Contra Costa County & Contra Costa County Water District Board Member
Brookside Hospital Board of Directors
Center for Third World Organizing
Center for Working Life
Community Action Center of Richmond
Barbara Cross, Mental Health Administrator Contra Costa County
Gray Panthers of Contra Costa County
Joe Gross, Richmond Concerned Resident
Lee Howard, Richmond NAACP
Joe Kinard, Richmond Chamber of Commerce
Don Lau, Richmond Unified School District Board
Morell Marshal, Economic Development Commission
Linda Mills, Attorney
Neighborhood Coordinating Council of Richmond
Ray Newman, Mental Health Worker Contra Costa County
Oakland Union of the Homeless
Fred Persily, Concerned Citizen
Plant Closures Project
Sidney Pucek, Planning Commission
Rainbow Coalition, 8th Congressional District
Andy Russo, Concerned Citizen
Delores Sanchez, Richmond Concerned Resident
Barbara Sanders, Housing Alliance Contra Costa County
7th C.D. Rainbow Coalition
Jordan Simmons, Performing Artist
Andres Soto, RUSD Bilingual Advisory Committee
Jeannie Thomas, Concerned Richmond Resident
West Contra Costa Peace Committee
West Contra Costa Rainbow Coalition
West Contra Costa County Toxics Coalition
Charles Wilson, El Cerrito NAACP*

Elected Officials

Tom Bates, California State Assemblyman
Leo Bazile, Oakland City Council
Sharon Brown, Mayor City of San Pablo
Bob Campbell, California State Assemblyman
Aleta Cannon, Oakland City Council
Rosemary Corbin, Richmond City Council
Ron Dellums, U. S Congressman, 8th Congressional District
Carter Gilmore, Oakland City Council
Richard Griffin, Richmond City Council
Elihu Harris, California State Assemblyman

more

Marge Gibson Haskell, Council Member City of Oakland Dist.1
Johan Klehs, California State Assemblyman
George Livingston, Mayor of Richmond
David MacDiarmid, Richmond City Council
John Marquez, Richmond City Council
James McMillan, Richmond City Council
Leonard McNeil, San Pablo City Council
George Miller, U. S. Congressman, 7th Congressional District
LaVonne Niccolls, Richmond City Council
Tom Powers, Contra Costa County Board of Supervisors
Wilson Riles, Jr., Oakland City Council
Pete Stark, U. S Congressman, 9th Congressional District
Lonnie Washington, Jr., Richmond City Council
John Ziesenhenne, Richmond City Council

Letters of Concern have been received from:

Asian Law Caucus
Dan Boatwright, California State Senator
John Burton, U. S. Congressman
Unified Brotherhood of Carpenters & Joiners of America Local 35
Edward M. Downer, III, Opportunity West
Rev. Paul Engberg, Parish of St. Patrick of Rodeo
Nancy Fahden, Contra Costa County Board of Supervisors
Dick Floyd, California State Senator
Greater Richmond Interfaith Project, GRIP
Phil Green, Mayor of Pinole
Susan M.Greene Ph.D.
Taalia Hasan, Youth Service Administrator Contra Costa County
Tom Hayden, California State Assemblyman
Phil Isenberg, California State Senator
Bill Lockyer, California State Senator
Leo McCarthy, California Lt. Governor
Sunne McPeak, Contra Costa County Board of Supervisors
Gretchen Marotti, Pinole Chamber of Commerce
Robert Mattingly, Int'l Brotherhood of Teamsters Local 896
Peter Olney, Int'l Garment Workers Union Organizer
Nicholas Petris California State Senate District 9
Tom Torlakson, Contra Costa County Board of Supervisors

* Organization listed for identification purposes only

plant
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project

May 9, 1989

Dear Sisters and Brothers,

CONGRATULATIONS! The Honest Deal Coalition has won another victory in our 9-month-long struggle to win justice for the 650 laid-off Safeway workers.

April 20 and 21 Safeway was forced back to the bargaining table to meet with Teamsters 315, other impacted Locals and Joint Councils to negotiate a contract for a new Safeway warehouse in Tracy and transfer and seniority rights for laid-off Richmond workers! This victory is shared by all the hundreds of union, community and religious groups as well as elected officials who joined together and demonstrated together for 9 long months! This victory is shared by the hundreds of laid-off Safeway workers and their families who remained strong and united in demanding their jobs.

The Honest Deal Coalition's most recent action, leafleting (see enclosed flyer) and speaking at the PG & E Shareholders Meeting on April 19th helped set the stage for the April 20 and 21 bargaining sessions. Special thanks to Assemblyman Bob Campbell, Rev. Allen Ramirez, Rev. Ron Swisher, and SEIU Local 790 Vice-President Marshall Walker III for sending letters to key PG & E Board Members. Present at the April 19 action as speakers were: Steve Roberti of the Contra Costa Co. Central Labor Council, Rev. Bill O'Donnell, Syd Hadsell and Ron Rhone, laid-off Safeway workers. Art Pulaski of the San Mateo Co. Central Labor Council and Walter Johnson of the San Francisco Labor Council also appeared to show their solidarity. Utilizing proxies provided by ESC-MEBA members Bernard Riley and Roger Johnson, laid-off Safeway workers Bruce Fong and Roy Holbrook, and Honest Deal Coalition supporter Veronica Fukson; Rev. O'Donnell, Syd Hadsell, Ron Rhone and Roy Holbrook were able to speak during the Shareholders Meeting and confront Magowan. Informational leafleting reached more than 1,500 PG & E shareholders. Leafleters included: Darleen Ward, Syd Hadsell, Ron Rhone, Roy Holbrook, Alex Tariosa, Charlie Elliott, Larry Roybal, Millie Phillips of IBEW 1245, and members of SEIU Local 1877 and HERE 2. Jon Fromer of the Freedom Song Network added some spirited song. Lincoln Cushing turned laid-off workers' ideas into some great decals and bumperstickers -- and Inkworks did some great printing work! Larry Roybal and Darlene Christensen were key organizers for the succcessful action. And THANKS to everyone who has been helping with the work of the Honest Deal Coalition!

more

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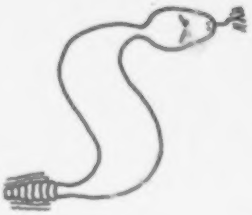
The Honest Deal Coalition is hopeful that Safeway finally understands that we will not go away until we win! We are hopeful that within a reasonable period of time Safeway will negotiate a fair contract and transfer and seniority rights. We will be watching carefully for the next month to see if words turn into firm commitments from Safeway.

We are ready to take our 9-months-worth-of-anger to KKR's fancy offices at 101 California in San Francisco. We are ready to flex our consumer power if Safeway needs another lesson in how united the hundreds of Honest Deal Coalition members can be.

We will keep our supporters informed as negotiations proceed between Teamsters and Safeway. We salute you, Honest Deal Coalition members and Local 315 members, for your strength and commitment! Together we are winning justice for the laid-off Safeway workers!



A friendly message **to PG & E Stockholders from the *Honest Deal Coalition* concerning PETER MAGOWAN, member of the PG & E Board of Directors and President of Safeway Stores.**

The *Honest Deal Coalition* believes PG & E's Board of Directors should be an example of the highest ethics in business. We question if Peter Magowan is such an exemplary businessman.

WHY?

Since July 1988 when a fire destroyed a Safeway warehouse in Richmond, 650 Safeway workers have been laid-off. These workers, their union Teamsters 315, and more than 200 churches, community groups, unions, small businesses and elected officials organized the ***Honest Deal Coalition*** to demand:

- just severance with no deadline
- Safeway involve the union and community in decisions about whether to rebuild or relocate the warehouse
- extend transfer rights so laid-off workers can follow their jobs
- extend seniority rights
- interim jobs for laid-off workers

WHAT HAS PETER MAGOWAN DONE?

It has been 8 MONTHS since the Safeway warehouse fire. 8 MONTHS of unemployment and low-paying jobs. To-date using demonstrations, press conferences, more than 20,000 petition signatures, more than 4,000 letters and calls, delegations of important religious leaders and elected officials, we have won from Safeway:

- just severance with no imposed deadline
- Safeway's public announcement they will not re-build in Richmond
- Safeway's agreement to meet with unions representing workers on April 20 & 21

Peter Magowan has a golden parachute from Safeway. Peter Magowan makes BIG BUCKS as President of Safeway. Kohlberg, Kravis & Roberts KKR, the buy-out kings who own Safeway are getting richer and richer. Safeway made record profits in 1988!

IS THIS JUSTICE? WE SAY NO!

SEND A MESSAGE TO PETER MAGOWAN!

You have a Voice for Justice as a PG & E Stockholder. You can protect PG & E's reputation from the bad business leadership of Peter Magowan. Tell Magowan you want justice NOW for laid-off Safeway workers.

- transfer rights
- seniority rights
- good-paying interim jobs

As a stockholder voice for justice, please also state your support for PG & E janitors, members of SEIU Local 1877. Demand ALL PG & E facilities have union janitors. Union jobs will mean:

- fair wages
- protected seniority
- fair health and welfare benefits
- fair grievance procedures
- job security

Honest Deal Coalition **c/o Plant Closures Project 415-834-5656**

plant
closures
project

PLANT CLOSURES/JOB LOSS--MYTHS & REALITY

Between 1979 and 1986 plant closures affected
13.5 million workers nationally
1.5 million workers in California
70,000 workers in the Bay Area
15,000 workers in Oakland

Only 60% of workers who lost jobs were able to find new jobs.

Only 53% of displaced women workers found a new job.
Only 47% of older workers found a new job.
Only 42% of Black workers found a new job.
Only 24% of high tech workers found a new job.

45% of those who did find a new job are now earning less than they earned before.

For each job lost in a plant closure 3 1/2 other jobs are lost in support industries, service jobs, and small businesses. The local tax base is directly affected because unemployed/underemployed workers pay less taxes and buy less and corporate taxes and fees are lost. At the same time our communities need more tax-supported services because of increases in homelessness, hunger, domestic violence and crime.

Primary causes of job loss include: mergers and buyouts, greedy corporate decisions for short term and higher rates of profit, union-busting, discrimination against older workers and women and ethnic minorities, deregulation, tax incentives, and foreign and military policies.

Job loss is not caused by high wages, unions, taxes, government health and safety or environmental laws.

Our country and community still needs industrial and manufacturing jobs and products. High tech and the service sector are not providing enough jobs nor are they providing good-paying and secure jobs. U.S. companies are heavily investing in foreign companies and countries--U.S. companies are themselves the "foreign competition". It is corporations and government policies that strip us and our community of jobs just as they are exploiting workers in foreign countries.

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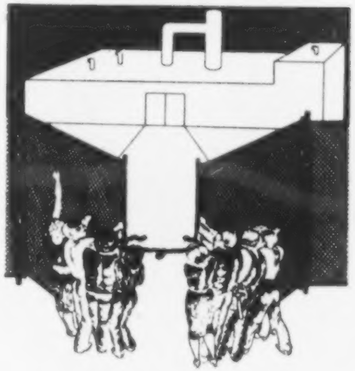
Help Stop
PLANT CLOSURES
and the threat to our jobs, families, and communities



Join the
PLANT
CLOSURES PROJECT
433 Jefferson Street
Oakland, Ca. 94607
(415) 834-5656

ADVISORY BOARD
of the Plant Closures Project

RABBI SAM BROUDE, *Temple Sinai*

REV. WARNER H. BROWN, *Director, The Council on Ministries, California-Nevada Conference of the United Methodist Church*

REV. EUGENE FARLOUGH, *Pastor, Sojourner Truth Presbyterian Church*

LILLIAN GALEDO, *Director, Pilipino Immigrant Services*

JOHN GEORGE, *Supervisor, County of Alameda*

ELIHU HARRIS, *Assemblyman, Thirteenth District*

REV. KATHY JOHNSON, *Northern California Ecumenical Council*

WALTER JOHNSON, *Secretary-Treasurer, San Francisco Labor Council*

PAT LAMBORN, *Santa Clara Committee on Occupational Safety and Health*

ED LOGUE, *Directing Business Representative, District 115, International Association of Machinists*

ETHEL LONG-SCOTT, *Women's Economic Agenda Project*

CHUCK MACK, *President, Joint Council 7, International Brotherhood of Teamsters*

STEVE MARTIN, *Executive Secretary-Treasurer, Alameda County Central Labor Council*

FLORENCE McDONALD, *Berkeley Activist*

JOSE MEDINA, *Instituto Laboral de la Raza*

GEORGE NANO, *Chair, Bargaining Committee, United Auto Workers Local 2244*

ABBA RAMOS, *International Organizer, International Longshoremen's and Warehousemen's Union*

WILSON RILES, JR., *Councilman, City of Oakland*

HARRY POLLAND, *Labor Economist*

REV. DR. J. ALFRED SMITH, *Pastor, Allen Temple Baptist Church*

Clip and mail to the **Plant Closures Project**, 433 Jefferson Street, Oakland, California 94607.
Or call (415) 834-5656

☐ I/my organization would like to make a financial contribution to the Plant Closures Project. Enclosed is a check for ________. (Please make checks payable to the Interfaith Council on Economic Justice and Work. Contributions are tax-deductible.)

☐ I want more information about the Plant Closures Project. Please contact me.

Name ____
Address ____
Street City State Zip
Phone ( ) ________________ ( ) ________________
Home Work
Organization ____
Position (if any) ____

PLANT CLOSURES PROJECT:

Unions, Religious Organizations, and Community Groups Working Together

Founded in 1981, the Plant Closures Project is sponsored by a wide range of unions, religious organizations, and community groups in the San Francisco Bay Area.

Plant Closures Project staff and volunteers help workers and communities address the problem of plant closures and job loss in several ways:

The Project can help you:

- recognize the early warning signs of plant closures and layoffs where you work
- analyze trends in your industry, such as new technology or changing market conditions, that may put a plant, shop, or office at risk of closure
- draft contract language which will help prevent plant closures or extend benefits to laid off workers
- analyze various strategies for stopping or delaying closures
- refer you to lawyers, job placement and financial counselors, mental health workers, and specialists in worker and community ownership

The Project can provide:

- speakers for union, religious, and community group meetings
- training sessions for union, church, and community leaders
- a resource library which includes legal cases, sample contracts, and general information on issues of economic dislocation
- a computerized listing of plant closures and layoffs in California, with information on the unions, industries, and legislative districts affected
- educational materials, including leaflets, brochures, and a newsletter, "Work Ethics"

The Plant Closures Project helps organize support for:

- public awareness of the causes and effects of economic dislocation
- campaigns to stop individual plant closures and major layoffs in our communities
- stronger state and national legislation to prevent plant closures and provide assistance to workers and communities in crisis
- programs of alternative economic development

Building a Movement:

The Plant Closures Project has contacts with coalitions, unions, and religious organizations working for similar goals around California and in other states and countries.

How the Plant Closures Project Works:

The Plant Closures Project office is located in Oakland at the Catholic Charities Building. The Project holds general meetings open to all members. The work of the group is carried out by standing committees on direct action, legislation, education, international connections, and newsletter and administration. An elected steering committee coordinates the work of the Project. The Plant Closures Project depends on financial support from private foundations and participating organizations and individuals.

How to Join:

The Plant Closures Project is open to everyone affected by the problem of plant closures or job loss. Just clip and mail the form on the reverse side, and the Project will contact you promptly.

7/86

TESTIMONY OF

ALBERT E. SINDLINGER AND RICHARD W. KLABZUBA

INTRODUCTION BY

HON. JOHN E. MOSS, MEMBER OF CONGRESS 1953-1979[1]

BEFORE THE

COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES

HEARINGS ON THE TAX POLICY ASPECTS OF MERGERS AND ACQUISITION

MR. MOSS. Mr. Chairman it is my privilege to present to the Committee Mr. Albert E. Sindlinger and Mr. Richard W. Klabsuba.

Mr. Sindlinger, the Chairman of the Board, Sindlinger & Company Inc., Wallingford, Pennsylvania, really needs no introduction to many members of Congress having testified numerous times before various committees of both the House of Representatives and the Senate over the past four decades. A leading expert in the field of consumer confidence, Mr. Sindlinger advised Banking and Currency Committee to raise the FDIC's insurance protection from $10,000 to $40,000 in August 1974 to regain depositers' confinence.

Mr. Klabsuba served on the staff of the House of Representatives from 1969 to 1979 in various positions with the Office of the Doorkeeper, the Committee on Interstate and Foreign Commerce, and the personal staff of several members. He also represented myself and 31 other members of Congress in a lengthy proceeding before the Civil Aeronautics Board known as the Domestic Passenger Fare Investigation. It was our participation in that hearing which brings us here today.

By way of background, throughout 1968 and 1969 my colleagues and I attempted to get the CAB to undertake a public hearing on airline fares. We felt such a proceeding was long over due since the agency had never conducted such an investigation in its 31 years of existence. By November of 1969 we became convinced the Board was violating the Federal Aviation Act of 1958 by setting fares without a public hearing. At Mr. Klabsuba's recommendation, my colleagues and I took the agency to court.

On July 9, 1970 the Court of Appeals for the District of Columbia ruled in our favor and found that the fares established by the Board without a public hearing were illegal.[2] As a consequence of our actions, the Board finally instituted the proceeding we had requested — making myself and my colleagues parties to that investigation. We accepted the Board's offer to do a little congressional oversight on a first hand basis, and appointed Mr. Klabzuba to be our representative.

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[1] Mr. Moss represented the Third District, California, currently represented by Hon. Robert T. Matsui, a member of the Committee on Ways and Means.

[2] Moss, et al. v. C.A.B., 521 F2nd 298 (1970).

Mr. Sindlinger also participated on our behalf by producing the first market demand study ever conducted on airline fares. The CAB's staff had contended such a study was impossible because of the nature of the business, but Mr. Sindlinger proved them wrong. I would like to thank Mr. Sindlinger again for his work on our behalf, not only because his report was eventually proven to be valid, but also because I would like the Committee to know he conducted that survey for us on a pro bono basis.

The Domestic Passenger Fare Investigation was divided into nine parts. Phase 8, Rate of Return, delt with classic regulatory questions of capital structure -- the proporations of debt and equity to be used for setting fares -- as well as the earnings to be allowed on those securities. Unfortunately, we had to give this phase a much lower priority than the other phases because of the issues involved. Return hearings are quite common, even the CAB had previously held one of those proceedings. A fare structure investigation, on the other hand, had never been conducted, so that is where we directed our efforts.

Nevertheless, the staff and I subsequently became intrigued by one aspect of that proceeding: the preferential treatment of debt. As the proportion of debt increased, fares went down; as the proportion of equity increased, fare went up —- a pattern which continued even when the cost of debt was increased significantly.

We did not understand the phenomenon. Due to the unstable nature of the airlines' earnings, one of our stated goals had been to improve the carriers equity position. However, it was apparent that something in the Board's ratemaking formula, or the relationship between debt and equity, was thwarting that effort. Mr. Klabzuba asked permission to continue looking into this problem after the investigation was over and I told him to "Go ahead." Now I want him to report to you what he found, and what he has recommended Congress should do to resolve the problem because it directly affects the current work of your committtee on corporate taxes.

MR. KLABZUBA. Thank you Mr. Moss.

Mr. Chairman, as we all now recognize, the phenomenon which Mr. Moss, myself and others were observing some 15 years ago in the CAB's ratemaking formula was the U.S. tax code at work. Even though the Committee is now aware of the tax code's preferential treatment of corporate debt financing, I believe the members can still get a better feeling for its practical, every day impact on a corporation's cost of capital by seeing how it was actually applied to the CAB's rates return in the Domestic Passenger Fare Investigation.

In 1971 the CAB found that U.S. airlines were entitled to an opportunity to earn a 6.2% return on debt capital, and a 16.75% return on equity capital after-tax.3/ The corporate tax rate, which Congress has mandated that all Federal regulatory agencies shall not reduce when establishing the cost of service, was 48%.4/ As a consequence, the CAB began in 1971 to set the carriers' rates and fares to yield a 32% return on equity before-tax -- a return five (5) times greater than it allowed earned on debt.

Given the substantial difference between these two returns before-tax -- 32% vs. 6.2% -- I think you can understand the predicament which your colleagues were faced with in the 1970's, and which you may have to face again if the tax code is not changed and the airlines are ever re-regulated. To improve the debt-equity ratio of the carriers in order to better protect the jobs and investments of some constituents, your colleagues had to support a government policy which would require most of their other constituents (and yours) to pay 5 times more for about five to ten percent of the carriers' total capital.

Economic regulation allowed Congress, through its Federal regulatory agencies, to set prices in this arbitrary manner by tightly controlling entry, markets and jobs. Within limits the system worked and the Members were able to get a number of airlines to improve their balance sheets. However, such pricing techniques will not work in a non-regulated or deregulated enviroment where entry, investment and job opportunities, and market competition are not severely limited.

In free markets, the cost of capital does not determine the price of goods and services, rather those prices determine the cost of capital and the resulting debt-equity ratios. In a free market, no one can adjust a profit margin upwards to pay more for equity or debt capital unless their competitors concur...and that's price fixing which is against the law.

As the Committee knows, in the latter half of the 1960's a combination of economic factors — inflation, falling productivity and increased foreign competition to name a few -- began exerting an increasing downward influence on corporate profit margins. To counteract these pressures, corporations began to slowly, but steadily reduce their outlays by closing outmoded plants, laying-off workers, reducing wages, and cutting capital costs and taxes by simply restructuring their corporation's debt-equity ratio.

As American corporations reliance on debt capital increased, interest rates began to rise and slowly overtake common stock yields, thereby creating the anomaly shown in the table accompanying our written testimony: Bonds providing investors a greater return than stocks. For the past 30 years the yield on corporate AAA bonds has exceeded the dividend yield of corporate common stock!

3/ CAB Order 71-4-58 (1971).

4/ Pub.L. 88-272, title II, Sec. 203(e), Feb. 26, 1964, 78 Stat. 35 (The Revenue Act of 1964). See 26 U.S.C. 38, Treatment of Investment Credit by Federal Regulatory Agencies.

Common stocks have, of course, continued to provide some investors greater returns when appreciation is taken into consideration. As the table indicates, over the past 40 years as Triple-A rated corporate bonds have quadrupled from 2.6% in 1949, the price/earnings ratio of common stocks has just about doubled, even though the dividend yield on those stocks has been cut almost in half percentagewise.

To further complicate this financial restructuring, as corporate bond rates began to quadruple, companies started shifting a greater portion of their growing debt into shorter term loans and open market paper in an effort to hold down their interest payments. Consequently, as the debt-equity ratios increased, the ratio of short-term debt-to-total outstanding debt likewise increased from around 30% in 1964 to over 50% in 1981.

In other words, U.S. corporations have used our tax code's current preferential treatment of debt capital to maintain their profit margins by completely restructuring their balance sheets — substituting short-term debt for long-term equity. Over the past thirty years, somewhere between 10 to 15 percent of our nation's corporate capital has been shifted from long-term investments into short-term obligations.

The need to make these structural changes to hold down capital costs before-tax has caught many of our corporate directors in a Catch 22 situation. As financial requirements have changed, investment opportunities have shifted, altering more and more investors' preceptions as to the most desirable debt-equity ratios, thereby producing a major conflict in investment strategies.

On the one hand, conservatively managed firms that have so far resisted the temptation to increase their debt-equity ratio may be financially sound, but they are increasingly vulnerable to a leverage buyout by investors more amenable to our tax code's current preferential treatment of debt financing. The airlines are an excellent example. The carriers that improved their balance sheets as your colleagues requested in 1971 are now threaten by hostile takeovers, as they should be. The government policy to improve the industry's financial soundness died with deregulation, and was replaced by the general rule: finance purchases with debt capital.

On the other hand, aggressively managed firms that have increased their debt are now more vulnerable to any weakness in their particular line of business. In addition, those firms that have increased their debt financing through increased short-term borrowing are now more exposed to both run-ups in interest rates as well as the potential threat of quicker withdrawals of a larger portion of their capital on a shorter notice when their short-term debts mature.

The current tax codes impact on financing strategies is probably most graphically demonstrated by the changes it has wrought in the middle layer of the capital structure —— that is, those securities in between senior debt and common stock. Once the sole domain of preferred stock, this layer has now been completely taken over by so-called "junk bonds".

Introduced a little over 12 years ago on April 6, 1977, junk bonds have grown from absolutely nothing into a $180 billion market that now represents 25% of the outstanding corporate bonds.

The reason for this success is quite simple. To attract more capital U.S. corporations have simply taken the corporate tax they would have paid on their equity earnings and tacked those funds on to the interest payments they are willing to normally pay on debt to derive the higher yields they will have to pay on junk bonds. The corporation gets more capital at the same or lower cost, while the investor gets a greater return on an investment security that will take precedent over preferred stock in case of liquidation or bankruptcy...and they call that "junk".

Having raised the question of financial strength, I am sure the Committee is aware of the widely pubished reports that many economist have stated they anticipate a recession sometime in the next three years. Some of these economists believe that as a result of the tremendous explosion in corporate debt, the next recession could be our harshest since World War II. So many firms must now function at extraordinary efficiency to just survive that any significant drop in their sales and profits could quickly put them under.

The magnitude of this potential problem has been dramatically measured by John E. Silva, an economist with Kemper Financail Services, Inc. According to Mr. Silva's figures, the portion of corporate profits devoted to interest payments before-tax has increased *six-fold* over the past 30 years from just 8% in 1959 to 48% in 1988.

The figures on an after-tax basis are even more troublesome. Mr. Silva's data indicates that debt servicing gobbled up 88% of our corporations' after-tax profits in 1986, 1987 and 1988.

The underlying reason the debt service has continued to stay at these extremely high levels is simply that despite the fact the continued demand for debt has pushed Triple-A bond rates upto 9.5% in 1988 while cutting the cost of equity capital down to 8.5% on an earnings/price basis, long-term debt is still *26% cheaper* than equity before-tax -- even though the corporate tax rate itself has now been cut to 34%.

Having recognised many, but not all, of the implications of this preferential treatment of debt financing, and published those findings in *The Sindlinger Alert* in 1986 and 87, I traveled the country from coast to coast, and border to border, for two years seeking ideas on how to get rid of this discrimination. Most of the individuals to whom I talked, who are your constituents, identified the excess activity in mergers and acquisitions, leveraged buyouts and junk bonds as a tax problem, not a security one. These constituents also recognised that all these activites were merely the tools that had to be used to carry out the government policy of fostering debt financing.

Many solutions were offered, most of which are contained in the Committee's press release of April 12, 1989. Standing alone, none of the proposals appeared to be economically sound or easily administrable. In a word, they were not politically practical. However, when two of the suggestions are combined into a two-part package, something beautiful happens -- the legislatively created discrimination between debt and equity capital disappears.

The proposal, which was first published in Sindlinger's Household Liquidity on March 22, 1989, is relatively simple:

> One, cut the current 100% tax deduction for interest payments in half, in exchange for
>
> Two, a new 100% tax deduction for cash dividend payments.

Assuming a 50:50 debt-equity ratio, and a 50:50 split between retained earnings (which would continue to be taxed) and cash dividend payments (which would cease to be taxed at the corporate level), the impact on government revenues could be neutral. The loss of revenues on equity capital earnings would be replaced by a similar amount of revenue from the earnings on debt capital.

These assumptions, of course, do not reflect the real world. At the present time the proportion of debt tends to be greater than equity, while cash dividends are substantially less than retained earings; dividends are probably closer to 40% of net earnings after-tax. In addition, the after-tax yield on Triple-A corporate bonds was still about one percentage point greater than that on common stocks in 1988.

As a result, this tax proposal could possibly generate some additional government revenues initially during the transition period depending upon how Congress implements the proposed tax change, and how interest rates and American corporations react to those changes.

Since the capital structures of many American corporations are now predicated upon the tax code's current preferential treatment of debt financing, we would anticipate that Congress would allow a fair and adequate transition to a non-discriminatory basis -- a transition similar to that provided individual taxpayers by the Tax Reform Act of 1986 for the phase-out of their personal interest deductions.

For purposes of illustration, a four year transition that would begin in 1991 might be phased in as follows:

Year	Interest Deduction	Cash Dividend Deduction
1990	100%	0%
1991	88	25
1992	75	50
1993	63	75
1994	50	100

When looking at this schedule the important point to note is that to maintain mathematical symmetry, and therefore revenue balance, the cash dividend deduction should be increased two (2) percentage points for every one (1) percentage point reduction in the interest deduction in order to achieve the respective 50 and 100 percent levels simultaneously.

While budget constraints make it necessary for the Committee to consider the revenue impact of any and all tax proposals, it should not be overlooked that by cutting the interest deduction in half, this particular tax proposal should cut the demand for debt financing — thereby exerting a long-term downward pressure on interest rates. Should that turn out to be the case, then this tax proposal's primary impact on the Federal budget will not be on the revenue side through higher taxes, but rather on the outlay side through lower interest payments on the Federal debt. That is to say, one of the primary benefactees of this tax proposal may be the Appropriations Committees.

From a practical and administrative viewpoint the implementation of this tax option is extremely simple. It requires no change whatsoever in the manner in which income is reported to (and by) shareholders and lenders. Consequently, this tax proposal requires no change in any of the forms used by these two groups to report their income to the Internal Revenue Service.

Only the corporate tax forms would need to be changed by (1) adding a line for the deduction of cash dividends paid, and (2) a revision of current report of their interest deductions to reflect the change in percentage allowed.

In addition, since U.S. corporation already report all their interest payments and cash dividend distributions to the Interal Revenue Service on Form 1099, the only additional workload which might be imposed on the IRS and taxpayers might be the totaling of the dividend payments, provided such total are not presently being computed as audit checks.

As an additional selling point, it should also be noted that the foregoing method of eliminating the double taxation of dividends would appear on it face to be much less complicated (and possibly fairer) than providing stockowners a tax credit on earnings distributed to shareholders as a dividend.

There are several other features of this particular proposal which I should like to touch on briefly, the first being that it does not seek or attempt to influence the allocation of credit to specific uses, or to specific individuals or corporations, American or foreign.

The proposal also does not discriminate between investors whether they are shareholders or lenders, American or foreign. Everybody is treated the same.

Finally, the proposed tax change provides Congress with an easier way to vary the interest deduction to assist the Federal Reserve Board in carrying out its duties to regulate the value of money and credit. It is afterall a lot easier to stimulate the demand for credit by increasing the tax deduction for interest from 50 to 55 percent, than from 100 to 110 percent, even though the impact is the same.

While the Federal Reserve Board may never want or need such Congressional assistance in regulating monetary policy, the ability to provide such assistance would still be there if this tax proposal is adopted...and that, in and of itself, could provide some relief to the agency from the onus it must now bear almost exclusively.

To summerize, historical economic phenomenon indicates that:

1. The current U.S. tax code discriminates between debt and equity by providing corporate debt financing preferential tax treatment;
2. The preferential tax treatment of debt financing implies a U.S. government policy to increase corporate debt; and
3. Mergers, acquisitions, leveraged buyouts, junk bonds, et cetera are merely some of the financial tools used by the public to carry out the government policy of increasing corporate debt.

To eliminated the statutory discrimination between debt and equity, I have recommended the Congress change the current tax code by:

1. Cutting the interest deduction in half to 50%, in exchange for
2. Instituting a new 100% tax deduction for cash dividend payments.

This two-part package appears to have the potential of achieving at least five worthwhile goals:

1. The equalization of the tax treatment of debt and equity financing through the elimination of the tax code's current preferential treatment of debt financing;
2. The elimination of the double taxation of dividend earnings paid without any change in the manner income is reported to, and by, shareholders;
3. A reduction in interest rates due to a curtailment in the demand for credit as a result of the 50% cut in the interest deduction;
4. A reduction in the Federal deficit primarily through a cut in interest rates and outlays, rather than any potential increase in tax revenues; and
5. The provision of a new or better legislative tool for assisting the Federal Reserve Board to regulate our economy; i.e., the statutory variation of tax code's interest deduction.

That is our proposal. A great number of people throughout our country help to formulate this proposal and to test its viability, so I would like to this opportunity to thank them for their assistance.

Now I am going to turn the podium over to Mr. Sindlinger who will address some of the other issues raised by the Committee.

MR. SINDLINGER. Mr. Chairman, I simply want to re-emphasize that this tax proposal is nondiscriminatory. It does not discriminate between debt and equity capital. It does not discriminate between investors, American or foreign. Should an investor buy an American firm through a leveraged buyout, the purchased corporation's interest tax deduction will be the same regardless of whether the investor is American or foreign.

We have submitted this tax proposal to almost a hundred leading economists around the country for their review. Several of these economists have indicated that while they like the concept of the proposal, they are troubled by the precedent it could establish for eliminating an obvious business expense as a tax deduction.

Interest on debt is a cost of doing business, but so are the earnings on equity, which is one of the reasons Federal and State regulatory agencies recognize both returns in establishing their cost of service. The other reason these agencies treat debt and equity the same is that the courts also consider interest and earnings legitimate business costs when reviewing their decisions. None of these government instrumentalities discriminates between debt and equity capital except as provided by contract or statute.

The reason is simple: debt and equity are interchangeable. One can be substituted for the other should it become relatively dearer. As a result, removing the statutory discrimination between these two costs of doing business will not establish a precedent for eliminating any other business expense as a tax deduction, but rather legislatively acknowledge their affinity.

Mr. Chairman, that concludes our written testimony.

Sindlinger & Company, Inc.
P.O. Box E
Wallingford, PA 19086
(215) 565-0247

Table 1

THE PERFORMANCE OF STOCKS VERSUS BONDS — BY YEARS

	(1) Price/Earnings Ratio (Year-End)	(2) Earnings Yield, % (Year-End)	(3) Corporate AAA Bond Yield, %	(4) Ratio Bond Yield/ Stock Yield	(5) Ratio Stock Yield/ Bond Yield	(6) Dividend Yield % (Year-End)
		100/ (1)		(3) / (2)	(2) / (3)	
1926	10.9	9.2	4.7	0.51	1.96	5.1
1927	15.9	6.3	4.6	0.73	1.37	4.3
1928	17.4	5.7	4.6	0.81	1.24	3.5
1929	13.3	7.5	4.8	0.64	1.56	4.5
1930	15.8	6.3	4.6	0.73	1.37	6.4
1931	13.3	7.5	4.6	0.61	1.63	10.1
1932	16.8	6.0	5.0	0.83	1.20	7.3
1933	23.0	4.3	4.5	1.05	0.96	4.4
1934	19.4	5.2	4.0	0.77	1.30	4.8
1935	17.7	5.6	3.6	0.64	1.56	3.5
1936	16.8	6.0	3.2	0.53	1.88	4.2
1937	9.3	10.8	3.3	0.31	3.27	7.6
1938	20.3	4.9	3.2	0.65	1.53	3.9
1939	13.9	7.2	3.0	0.42	2.40	4.9
1940	10.1	9.9	2.9	0.29	3.41	6.3
1941	7.5	13.3	2.8	0.21	4.75	8.2
1942	9.5	10.5	2.9	0.28	3.62	6.0
1943	12.4	8.1	2.8	0.34	2.89	5.3
1944	14.3	7.0	2.8	0.40	2.50	4.8
1945	18.1	5.5	2.6	0.47	2.11	3.8
1946	14.4	6.9	2.5	0.36	2.76	4.6
1947	9.5	10.5	2.6	0.25	4.04	5.5
1948	6.6	15.2	2.8	0.18	5.43	6.1
1949	7.2	13.9	2.6	0.19	5.35	6.8
1950	7.2	13.9	2.6	0.19	5.35	7.2
1951	9.7	10.3	2.8	0.27	3.81	5.9
1952	11.1	9.0	3.0	0.33	3.00	5.3
1953	9.9	10.1	3.2	0.32	3.16	5.8
1954	13.0	7.7	2.9	0.38	2.66	4.3
1955	12.6	7.9	3.0	0.38	2.63	3.6
1956	13.7	7.3	3.4	0.47	2.15	3.7
1957	11.9	8.4	3.9	0.46	2.15	4.5
1958*	19.1	5.2	3.8	0.73	1.37	3.2*
1959	17.7	5.6	4.4	0.79	1.27	3.1
1960	17.8	5.6	4.4	0.79	1.27	3.4
1961	22.4	4.5	4.4	0.98	1.02	2.8
1962	17.2	5.8	4.4	0.76	1.32	3.4
1963	18.7	5.3	4.2	0.79	1.26	3.0
1964	18.6	5.4	4.4	0.81	1.23	3.0
1965	17.8	5.6	4.5	0.80	1.24	2.9
1966	14.5	6.9	5.1	0.74	1.35	3.6
1967	18.1	5.5	5.5	1.00	1.00	3.0
1968	18.0	5.6	6.1	1.09	0.92	3.0
1969	15.9	6.3	6.9	1.10	0.91	3.4
1970	18.0	5.6	7.8	1.39	0.72	3.4
1971	17.9	5.6	7.4	1.32	0.76	3.0
1972	18.4	5.4	7.3	1.35	0.74	2.7
1973	12.0	8.3	7.6	0.92	1.09	3.5
1974	7.7	13.0	8.2	0.63	1.58	5.3
1975	11.3	8.9	8.6	0.97	1.03	4.1
1976	10.8	9.3	8.4	0.90	1.11	3.8
1977	8.7	11.5	8.1	0.70	1.51	4.9
1978	7.8	12.8	8.7	0.68	1.47	5.3
1979	7.3	13.7	9.5	0.69	1.44	5.2
1980	9.2	10.9	11.7	1.07	0.93	4.5
1981	8.0	12.5	13.9	1.04	0.90	5.4
1982	10.4	9.6	13.8	1.44	0.70	5.1
1983	11.7	8.5	12.0	1.41	0.71	4.3
1984	10.1	9.9	12.7	1.28	0.77	4.6
1985	14.5	6.8	11.4	1.77	0.56	3.7
1986	16.7	6.0	9.0	1.50	0.67	3.4
1987	14.1	7.1	9.4	1.32	0.75	3.6
1988	11.7	8.5	e9.5	1.12	0.89	3.5